CALIFORNIA
Senate
Republican Caucus

Highlights and Analysis of the Governor's Budget

January 12, 2005
SENATE REPUBLICAN FISCAL OFFICE

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Executive Summary

The Governor's Budget for 2005-06 proposes total State spending of $111.7 billion ($85.7 billion General Fund). While this represents a reduction of $5.8 billion when compared to projected current-year total spending, it contains a $3.4 billion increase in General Fund spending. Through a series of spending reductions, the continued use of economic recovery bonds, a pension obligation bond, and a number of significant reforms, the Budget addresses a multi-year deficit of $9.1 billion. Spending reductions in this year's budget are far more sweeping and comprehensive than those proposed in previous years, and, when combined with the budget reform proposals contained within, present a bold approach to aligning State revenues with State expenditures.

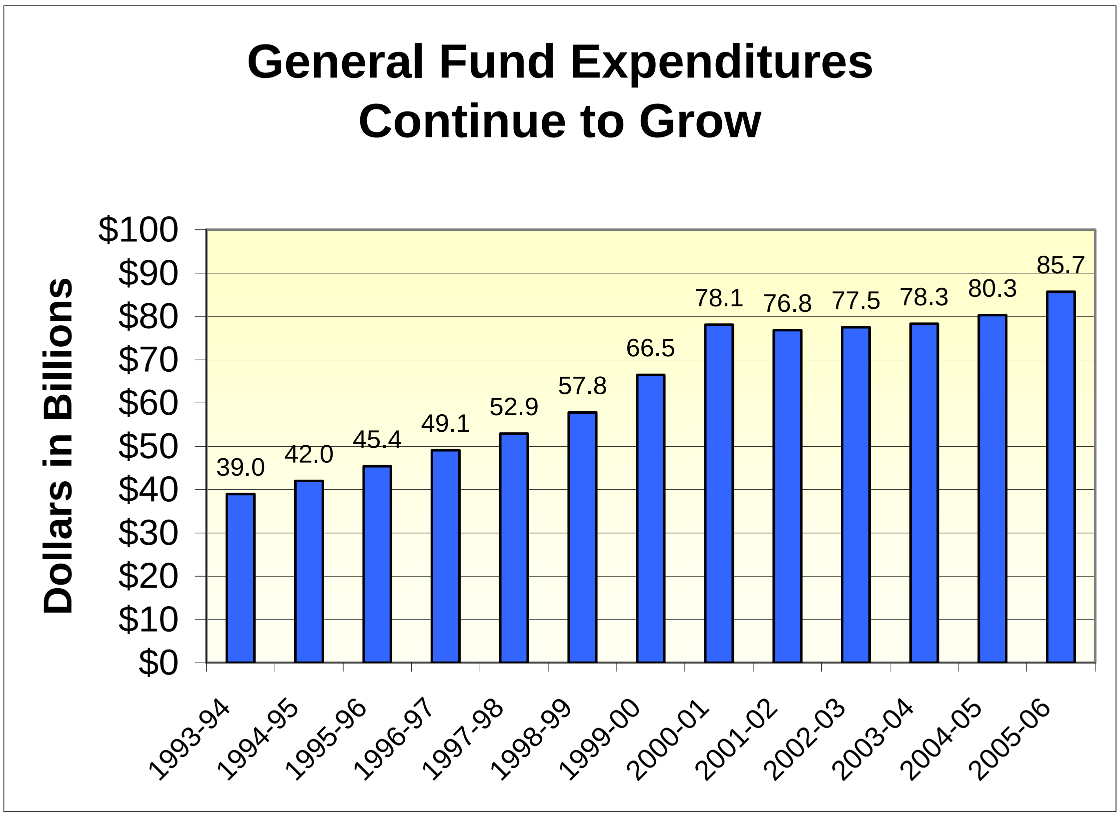
However, it is also important to note that the 2005-06 Budget does spend more than the State receives in General Fund revenue, and while the budget contains a number of "reductions," these reductions only slow the rate of overall spending growth. General Fund spending continues to grow year over year in the Budget, and the Budget balances in part due to billions in borrowing. Thus, while the Budget does propose serious and significant reforms, there is room for further reductions that could improve the financial health of the State, while still protecting vital State services.

The Governor's Budget Control Proposal. The 2005-06 Budget calls for major structural reforms that would significantly alter the way the State spends its revenue. The proposal contains six key components, the details of which are discussed further in this document. The cornerstone of the proposal will strengthen Proposition 58 requirements for a balanced budget, giving the Governor the ability to intercede when expenditures exceed available revenues, and authorizing "across-the-board" reductions when the Legislature and the Governor have failed to agree on a course of action. Additional components of the proposal include major Proposition 98 funding reform, Proposition 42 reform, Special Funds borrowing reform, debt consolidation, and significant public employee pension reform. While there are many details that must be reviewed in association with this ambitious reform package, it is clear that in proposing these reforms the Governor has set an agenda for fiscal reforms that could dramatically improve the fiscal climate of the state of California.

The Budget Contains No New Taxes. When faced with similar budget problems, previous Administrations have called for tax increases. This year's budget does not propose any new taxes, and instead uses a variety of other solutions to bring expenditures in line with revenues. In so doing, the Budget will not risk causing the drag on economic recovery that often accompanies tax increases. This policy of rejecting new tax proposals reflects recognition of the state budget problem as a spending problem, versus a revenue problem. Indeed, with no change in tax policy, revenues are expected to increase $5.3 billion between 2004-05 and 2005-06.

General Fund Spending Will Rise in 2005 Despite Proposed Spending Reductions. There will be considerable debate surrounding the budgetary "reductions" proposed by the Administration, however, as illustrated in Chart 1 below, State General Fund spending will increase in 2005-06. Indeed, except for a slight reduction in 2001 (which, incidentally, followed a year in which General Fund expenditures increased $11.6 billion) General Fund expenditures have increased in each of the past twelve years.

Chart 1

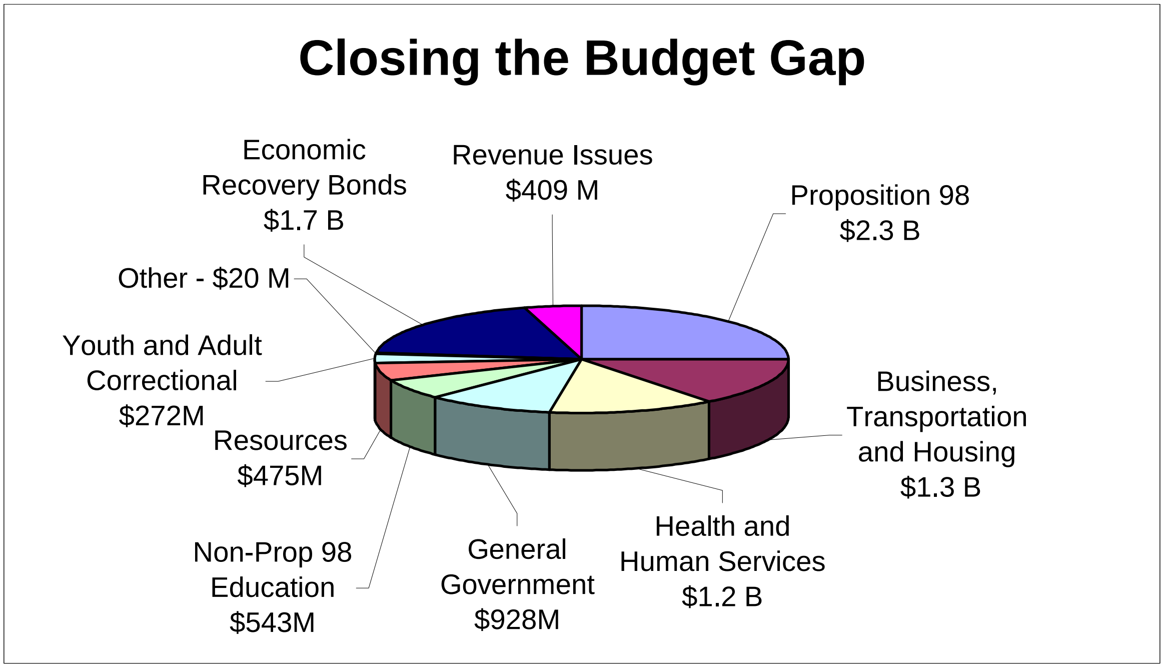


The Budget and the associated Budget Control Proposals could fully address California's chronic annual budget shortfall problem. However, without the associated reform measures, the Budget will not prevent additional budgetary shortfalls in 2006 and beyond, and will likely leave a $6 billion General Fund hole for 2006.

The Budget Slows Growth in General Fund Spending. The Budget contains $7 billion in total spending reductions, and $2.1 billion in revenue solutions. As is indicated in Chart 2, spending reductions contained in the Budget cover a number of state program areas. The Administration presented a much more comprehensive spending reduction proposal for 2005-06 than was proposed last year, with budget solutions proposed for nearly every agency in state government. However, despite the proposed spending reductions, overall spending for a number of categories will grow next year. As proposed, Proposition 98 education funding will increase $2.4 billion, Health and Human Services funding will increase $1.2 billion, and Higher Education will receive an additional $677 million in General Fund 2005-06. These increases alone total $4.3 billion.

So, although there will likely be considerable resistance to the reductions proposed in the Governor's Budget, many of the reductions are only reductions to a rate of growth in spending, and there is still room for additional budget reductions that could further improve the financial standing of the State while simultaneously protecting key programs from a year-over-year reduction.

Chart 2



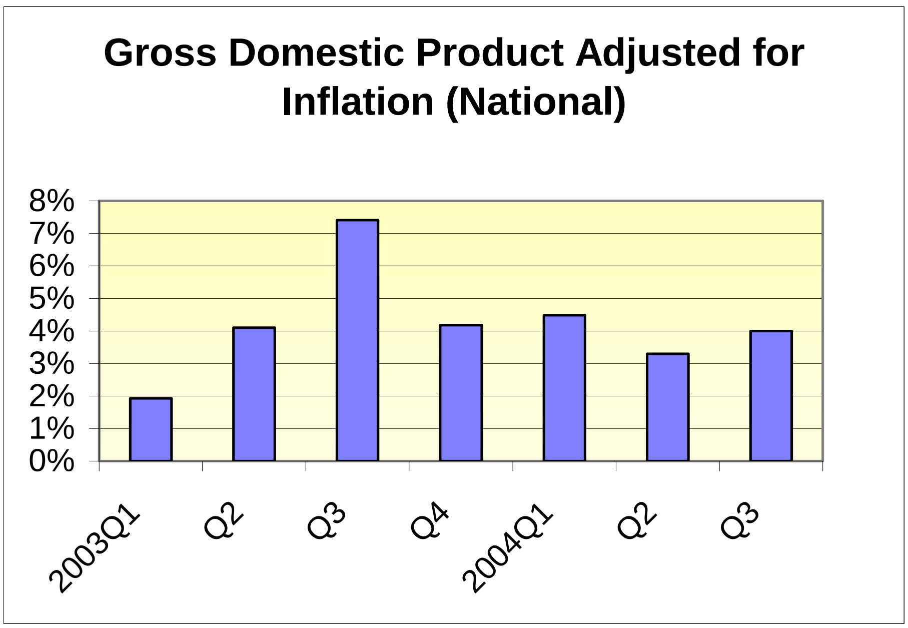
Borrowing is Still an Integral Component of the Governor's Budget. The Budget contains $2.9 billion in external borrowing. External borrowing refers to $1.7 billion in Economic Recovery Bond (ERB) funds, as well as a $765 million pension obligation bond (POB), and a $464 judgment bond proposed to pay the costs of the Paterno v. State of California lawsuit regarding flood victims. The Budget also relies on $1.3 billion in Proposition 42 transportation funds, and an additional $2.3 billion in Proposition 98 funds owed to K-14 education. When combined, this totals over $6.5 billion in borrowing or funding deferrals for 2005-06. While this total is less than was proposed in 2004-05, there is some concern with the level of borrowing proposed in the Budget, and it will likely result in additional difficult budget choices in future years.

In 2004, $12.3 billion of the $15 billion in available Proposition 57 bonding proceeds were used to pay off the accumulated budget deficits. Utilizing additional ERB funds in 2005-06 as proposed would leave approximately $2 billion in remaining bond funds to help address future budget gaps. As was recently pointed out in the Legislative Analyst's Fiscal Outlook, there are a number of one-time or limited-term budget solutions that will expire in 2006-07, including the $1.3 billion diversion in local property taxes agreed to in 2004-05, and the $765 million pension obligation bond now proposed for 2005-06, as well as a number of other solutions, all of which total several billion dollars in additional spending pressure.

Given the limited availability of ERB funds, and given that there will likely be a considerable budget shortfall in 2006-07, it might be too soon to rely upon the use of these funds, particularly since the State is still spending more each year than it is taking in, and the ERB funds are to some extent facilitating that excessive spending. Instead, it may be more prudent to further bring expenditures in line with revenues in 2005-06, thereby leaving more ERB funds to address any pressing expenditure needs that may arise in 2006-07.

Chart 3

Economic Outlook



The national and California economies improved considerably in 2004. Output of the national economy grew at almost its fastest rate in 20 years. Personal income and taxable sales growth picked up significantly in California, and State exports rebounded. Labor markets strengthened in both the State and the nation. Output of the national economy is predicted to grow somewhat slower in 2005 and 2006, but will still be sufficient to build on the improvement made in the labor markets in 2004. In addition, growth in personal income and wages and salaries, in both the State and the nation, are predicted to remain near the improved levels seen in 2004, as increased competition for workers results in bigger raises and bonuses.

National – Economy Improves, But Growth Likely to Slow in 2005

Output of the national economy and labor markets improved in 2004 despite soaring energy prices, the waning of the fiscal stimulus of the federal tax cuts of the prior three years, and tightening monetary policy. Increased federal spending gave the economy a boost, as did historically low mortgage rates and other long-term interest rates. Growing consumer spending, business investment, federal government spending, and exports have driven much of this economic recovery.

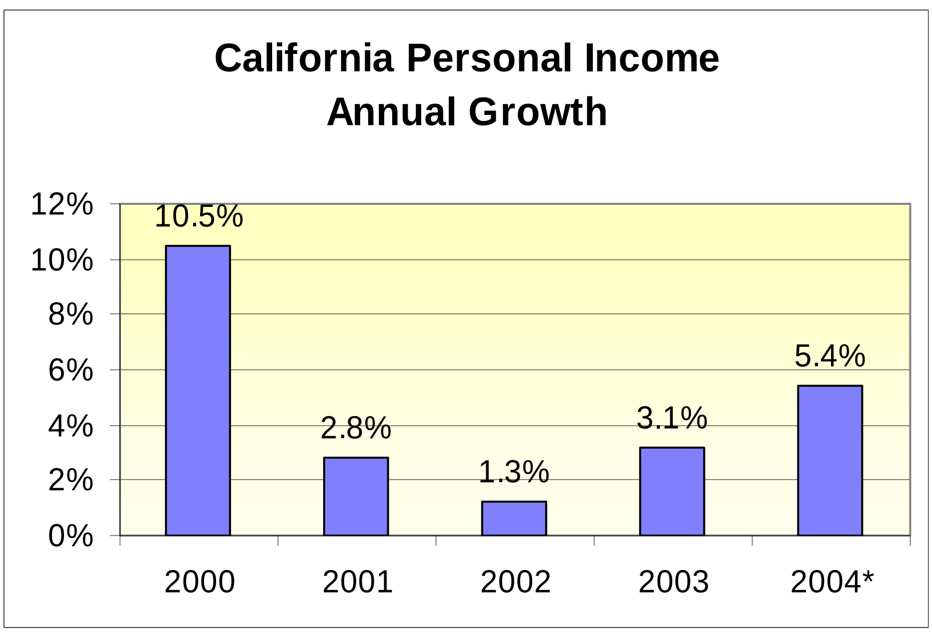
As indicated in **Chart 3** above, output growth of 4 percent in the third quarter of 2004, was more than enough to lock in annual average growth of above 4 percent for the year. However, Department of Finance is predicting that the fast economic growth in 2004 also means the initial phase of the economic expansion is over and that the strongest growth of the recovering economy might well be behind it. In fact, signs coming from the economy near the end of 2004 hinted that growth was slowing as 2005 neared.

Nonfarm payroll employment is expected to grow by about 2.2 million, or 1.7 percent, in 2005 and 1.6 million, or 1.2 percent, in 2006. Even though this will be a significant improvement on the 1-percent gain in 2004, it is modest compared to gains in most other post-World War II economic recoveries. Faced with rising benefits costs, employers will remain conservative about hiring. Furthermore, productivity gains will allow them to expand output without adding considerably to payrolls.

California—Economic Improvement Continues

The California economy also strengthened in 2004. Broad economic measures like personal income and taxable sales grew more quickly. Exports of made-in-California merchandise posted a good gain after plummeting for three years. Residential construction increased again. New business incorporations also accelerated.

Chart 4



*The 2004 figure is an estimate

Personal income - income received by California residents from all sources - was up 5.4 percent from a year earlier in the first half of 2004 **(see Chart 4).** A year earlier, personal income was up only 2.4 percent. On this broad measure, the State is doing a little better than the nation, where personal income grew by 5.1 percent in the first half of 2004 and 2.3 percent in the first half of 2003. Personal income growth is estimated to have grown by 5.6 percent in 2004 and is forecasted to expand by 5.8 percent in 2005, 6 percent in 2006, and 5.8 percent in 2007 - all slightly faster than the corresponding rates for the nation.

Statewide taxable sales also grew more quickly in the first half of 2004, with sales 6.1 percent higher than in the first half of 2003. In the first half of 2003, they rose only 3.3 percent. The most recent data on county taxable sales show that sales in the Bay Area rose for the second consecutive quarter in the fourth quarter of 2003. Before then, the Bay Area suffered nine consecutive quarters of year-over-year declines.

Made-in-California merchandise exports began to turn around in the fourth quarter of 2003 after falling by 26 percent in the preceding three years. In the first three quarters of 2004, exports were 20 percent higher than a year earlier. Increased exports to Mexico, mainland China, Japan, South Korea, France, Singapore, Hong Kong, Taiwan, and the United Kingdom were instrumental in the turnaround. Exports of computer and electronic products, transportation equipment, and machinery (except electrical) accounted for over three-quarters of the gain in total exports.

Non-farm employment, which is on track to grow by 1 percent in 2004, is projected to grow by 1.8 percent in both 2005 and 2006 and 1.7 percent in 2007. The strongest growth in 2005 is expected in construction, aerospace products and parts manufacturing, transportation and warehousing, motion picture and sound recording, professional and business services, and private educational and health services. The State's unemployment rate is forecast to average 6.2 percent in 2005, unchanged from 2004.

The State's economic fate is closely tied to the nation's. In the coming year, U.S. output growth is projected to slow somewhat, but wage and salary and personal income growth will pick up slightly.

Budget Control Reform Proposal

According to the Administration the Governor's "Budget Control Reform Proposal" initiative would require across the board reductions in all General Fund (GF) payments whenever (GF) revenues decline or (GF) expenditures increase by $250 million or more from the budget estimated amount. The Governor may then declare a fiscal emergency and call a special session. If the Legislature does not act within 45 days (or 30 days if a budget is not enacted), the Controller would be required to make across the board reductions in all GF payments, except for debt service and federally required payments. Proposition 98 and Proposition 42 would not be exempted. Additionally, the Legislature would not be able to act on any other legislation or adjourn until the bills addressing the fiscal emergency are enacted. The Department of Finance will be required to advise the Governor of revenues and expenditures annually in May and November.

If a budget is not enacted by July 1, appropriations will continue based upon the amounts equal to amounts appropriated in the prior budget act subject to the same conditions that applied in the prior fiscal year until a budget is passed.

In 2006-07, special funds will no longer be used for long-term General Fund loans. Repayment of payable mandate claims to local governments and special fund loans would be required over a period of time not to exceed 15 years.

State General Fund Revenue Forecast

2005-06 Revenue Sources
(Dollars in Millions)

	General Fund	Special Funds	Total	Change from 2004-05
Personal Income Tax	$42,895	$683	$43,578	$3,797
Sales Tax	26,947	4,332	31,279	2,013
Corporation Tax	9,015	0	9,015	337
Highway Users Taxes	0	3,441	3,441	85
Motor Vehicle Fees	21	4,993	5,014	176
Insurance Tax	2,300	0	2,300	70
Liquor Tax	315	0	315	3
Tobacco Taxes	115	920	1,035	-30
Other	3,846	9,470	13,316	2,592
Total	**$85,454**	**$23,839**	**$109,293**	**$9,043**

Current forecasts show continued revenue growth in 2005 and 2006. Estimated revenues for 2003 and 2004 are up $1.2 billion. As seen in the table above, total General Fund resources are $85.5 billion in 2005-06. General Fund revenues for 2005-06 are projected to be $83.2 billion, up an additional 6.8 percent or $5.3 billion from 2004-05. Revenue increases include gains in the three major State taxes: personal income tax; sales tax; and corporation tax.

General Fund revenues and transfers represent 78 percent of total State revenue. The estimate of General Fund revenue for 2005-06 includes the following main components:

- **Personal Income Tax (PIT)**. PIT revenues provide 50 percent of all General Fund revenues, and are forecasted to increase to $42.9 billion in 2005-06, up 8.5 percent from $39.5 billion in 2004-05. Current PIT forecasts assumes moderate growth will continue through 2006. Factors contributing to the increase in PIT include greater stock options and capital gains income predominately, which increased 30 percent in 2003, and is projected to increase 15 percent in 2004, and 10 percent in 2005, indicating a strengthening of the economy, compared to a reduction of 30 percent in 2002 and 57 percent in 2001.
- **Sales & Use Tax (SUT)**. SUT revenues provide 32 percent of all General Fund revenues, and are forecasted to increase to $26.9 billion in 2005-06, up 7.3 percent from $25.1 billion in 2004-05. Although SUT receipts are most generally associated with retail spending, which grew, by 4.3 percent in 2003, approximately one-third of taxable sales are attributable to business-to-business transactions. These include purchases of computers, telecommunications equipment, and building materials that go into the construction of new facilities.

- **Corporation Tax (CT)**. CT revenues provide 11 percent of all General Fund revenues, and are forecasted to increase to $9 billion in 2005-06, up 3.9 percent from $8.7 billion in 2004-05. This estimate reflects the strong corporate tax profits in 2004.

Economic Recovery Bonds. The Budget assumes the use of $1.7 billon in Economic Recovery Bonds. Approximately $2 billion in ERB bonding authority remains.

Reserve For Economic Uncertainty. The Budget assumes an ending reserve for the 2004-05 fiscal-year of $784 million and a year-end reserve of $500 million for fiscal year 2005-06.

Tax Issues

Once again, reaffirming his commitment to California's taxpayers, the Governor's proposed 2005-06 Budget contains ***no new tax increases***. The Budget recognizes the glaring fact that California has a spending problem and not a revenue problem.

Revenues from the temporary 0.25 percent sales tax rate imposed to repay the Economic Recovery Bonds are estimated at $1.167 billion in 2004-05 and $1.358 billion in 2005-06.

Last year several revenue generating measures were enacted. The budget includes revenues in 2005-06 derived from a two-year suspension of the teacher tax credit and the Natural Heritage Preservation Tax Credit, increased collection of the use tax on luxury vessels, and a tax amnesty programs for personal, corporation and sales tax. The table below indicates the anticipated revenues through 2006-07.

2004-05 Revenue Generating Measures
Summary of Fiscal Impact
(Dollars in millions)

	Fiscal Impact		
Description	**2004-05**	**2005-06**	**2006-07**
Teacher tax credit: two-year suspension	$210.0	$180.0	$0.0
Natural Heritage Preservation Tax Credit: two-year suspension	10.3	8.9	4.4
Vehicle, vessel, and aircraft use tax (sunsets July 1, 2006)	25.9	34.5	0.0
Tax amnesty program (net cash basis)	211.0	52.0	-27.0
Insurance subsidy dividends received deduction	8.0	9.0	7.0
A portion of the sales tax revenue on gasoline remains in the General Fund	128.0	0.0	0.0
Total	**$593.2**	**$284.4**	**-$15.6**

We note that $450 million in revenues anticipated from punitive damages awards are no longer assumed in 2004-05 or 2005-06. Additionally, the luxury use tax revenues may be overstated as a change in behavior of the owners might occur or negatively impact the industry. We look forward to the Legislative Analysts' report of the impact of the tax which is due in 2006.

Tax Relief

The Budget proposes $539.4 million for Tax Relief programs, which is $128.8 million less than the 2004 Budget Act.

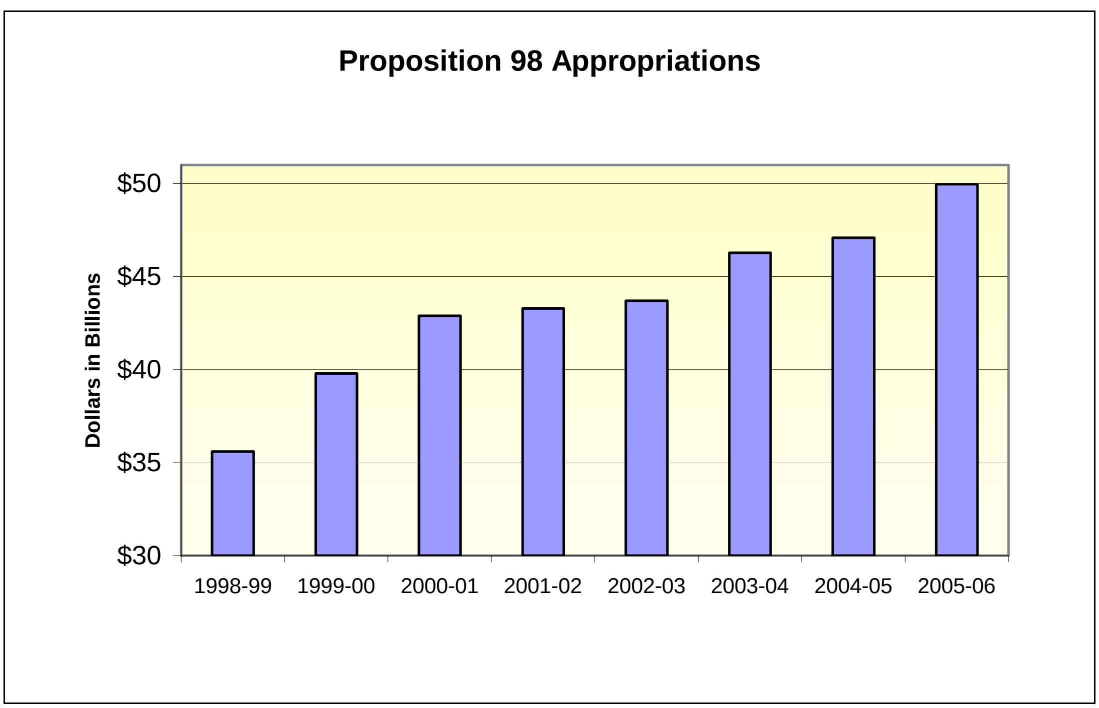
Senior Citizens' Property Tax Assistance Program. The Budget proposes replacing the Senior Citizens' Property Tax Assistance Program with expansion of the Senior Citizens' Property Tax Deferral Program and is expected to save $35.7 million.

Senior Citizen Renters' Tax Assistance. The Budget proposes to scale back program benefits to levels slightly above the 1998 level for a savings of $100.1 million. This program provides financial assistance to eligible low-income renters who are 62 years of age or older.

Education

Current Year Proposition 98 Funding Unchanged. In an effort to deal with the ongoing structural budget deficit, the Governor proposes to leave the current year Proposition 98 (Prop. 98) appropriation unchanged at about $47 billion rather than increasing it by $1.1 billion in recognition of recent General Fund revenue growth. Because such an increase would permanently increase the Prop. 98 base, withholding it will reduce the State's $9 billion 2005-06 structural budget deficit by about $2.2 billion. While critics tend to characterize lower-than-expected augmentations as "cuts," Chart 5 below demonstrates that Prop. 98 appropriations are actually continuing to grow from year to year, just as they have every year since Prop. 98 was enacted:

Chart 5



$2.9 Billion Increase in 2005-06. For 2005-06, the Governor proposes to increase Prop. 98 appropriations by about 6.1 percent ($2.9 billion), to $50 billion, a significantly higher increase than the overall State budget increase of 4.2 percent. As the table below shows, per-pupil funding would rise as well:

Prop. 98 and Per-Pupil Funding Continue to Grow in 2005-06

(Dollars in thousands)	**2004-05**	**2005-06**	**Difference**
General Fund	$34,123,805	$36,532,334	$2,408,529
Local property taxes	$12,959,387	$13,435,286	$475,899
Total	**$47,083,192**	**$49,967,620**	**+$2,884,428**
(Actual Dollars)			
K-12 Prop.. 98 per-pupil funding	$7,012	$7,374	+$362
K-12 total per-pupil funding	$9,864	$10,084	+$220

Revise Proposition 98 Funding Formula. The Governor proposes a ballot initiative to revise the Constitutional funding formula for K-12 schools and community colleges. Under the new model, the base budget for K-14 education would increase each year to reflect increases in the number of students served and the cost of living. The new model would not include an option to suspend the Prop. 98 minimum guarantee. Lawmakers would have the discretion to provide additional funding each year if they so chose, but any such additional funding would not increase the base (thereby avoiding creation of a permanently-increased obligation). If mid-year across-the-board cuts became necessary to keep the budget in balance, they would apply to every program in the budget, including education, unless specifically prohibited by the U.S. Constitution. In addition to these prospective changes, the budget proposes to extinguish the State's existing $3.7 billion "maintenance factor" obligation by repaying it over 15 years, beginning in 2006-07. Those payments would not permanently increase the Prop. 98 base.

Equalization. No funding is provided for equalization of school district revenue limits.

Expand Authorization Process for Charter Schools. Currently only K-12 school boards can approve new charters. The Governor proposes to expand the process by which charter schools are established so that colleges and universities can authorize charter schools.

More Local Control Over School Budgets. The budget proposes a California Local Education Accountability Reform (CLEAR) program in which up to 10 districts may voluntarily participate in 5-year pilot to delegate budgetary control to the school-site level.

Renewed Focus on Career Technical (Vocational) Education. The Governor proposes to spend $20 million from the Proposition 98 Reversion Account to:

- Inform middle school students of career/technical education options
- Add career/technical education information to the School Accountability Report Card (SARC)

- Improve coordination between K-12 and higher education through articulation (the process by which high school and college courses are structured to cover essential material and build smoothly on each other without overlap).
- Make it easier for community colleges to hire qualified career/technical instructors by exempting them from the "75 percent rule" which requires that 75 percent of the colleges' instructors be hired as full-time employees

Reform Taxpayer-Supported Child Care. The budget proposes the following child care reforms, which will reduce Prop. 98 child care expenditures by almost $95 million:

- Limiting the number of years that taxpayers will subsidize recipient families' child care
- Capping provider reimbursement rates so that the State doesn't pay more for child care than do non-subsidized families in the same community
- Ensuring that CalWorks (welfare) and non-CalWorks families with equal incomes get equal access to taxpayer-subsidized child care
- Reducing rates paid to license-exempt providers so as to provide an incentive for them to seek the additional training required for licensure
- Requiring counties to develop centralized child care waiting lists
- Changing the basis of family income eligibility for child care from the State median income to 210 percent of the federal poverty level. (No currently-subsidized families would lose service under this proposal).

Other notable Prop. 98 adjustments to the education budget include:

- **$2 billion for growth and cost of living adjustments (COLA)**. The budget provides full funding for 0.79 percent anticipated growth in average daily attendance ($394.7 million) and a 3.93 percent cost of living adjustment ($1.65 billion). These unrestricted funds may be used by school districts for whatever purposes they deem necessary or desirable.
- $328 million to **reduce the K-12 deficit factor** to about 1.13 percent
- $29.5 million for **deferred maintenance**
- $17.2 million for **instructional materials**
- **expand local budget flexibility** by adding four new programs ($361.7 million) to the professional development block grant

Reduce Funding for Public Library Foundation (PLF). The Governor's budget proposes to reduce funding for the PLF by about 15% ($2.2 million in non-Prop. 98 General Fund), maintaining total PLF funding at $12.2 million.

Proposition 98 Reversion Account. The Governor proposes to spend $138.6 million from Prop. 98 funds formerly appropriated but not expended for their original purposes, as follows:

- $100 million for **school facility emergency repairs** as required by the Williams settlement (SB 6, Ch 899, Statutes of 2004)
- $20 million to the community colleges to develop **career technical education** curricula
- $10 million for CalWorks **child care** base adjustments

- $4.9 million to fund a court-ordered payment for past Sunnyvale **desegregation** costs
- $2.3 million to fund the increasing cost of the California Standardized Testing and Reporting (STAR) program, which is the backbone of the State's testing and accountability system
- $1.1 million over 3 years to improve fiscal stability in K-12 schools by **training school district chief business officers**
- $354,000 to fully fund free and reduced price **school meals** served in previous years

Higher Education

UC / CSU Compact Continues. The Governor's proposed funding for 2005-06 higher education adheres to the terms of the compact he made with UC and CSU in 2004, which focused on predictability of institutional funding and student fees over time. Most notably:

- **Institutional funding increases** are proposed at 3% for both UC and CSU ($76.1 million and $71.7 million, respectively)
- To **eliminate 2004-05 legislative augmentations for outreach**, unallocated reductions would apply to both UC ($17.3 million) and CSU ($7 million), leaving UC with $12 million and CSU with $45 million for outreach, as provided in the original compact.
- **Enrollment growth** would be funded at 2.5% for both UC and CSU ($37.9 million and $50.8 million, respectively)
- **Student fees** rise predictably over a 3-year period. UC has already set 2005-06 its fees at $6,769 for undergraduates and $8,556 for graduate students. CSU has set its fees at $3,102 for undergraduates and $3,684 for graduate students (except for teaching credential students whose fees are $3,504).
- The new **UC Merced** campus is budgeted at $24 million, including $14 million in one-time funds
- Funding for the **UC Labor Institute** ($3.8 million) is eliminated

Community College Funding Grows. The 2005-06 budget provides $7.9 billion in total funds ($5.2 billion from Prop. 98) for community colleges. This represents a 5 percent funding increase, and the colleges' share of Prop. 98 will rise to 10.35 percent. Existing student fees of $26 per unit, the lowest in the nation and waivable for low-income students, will not rise in 2005-06. Major adjustments to the colleges' budget include:

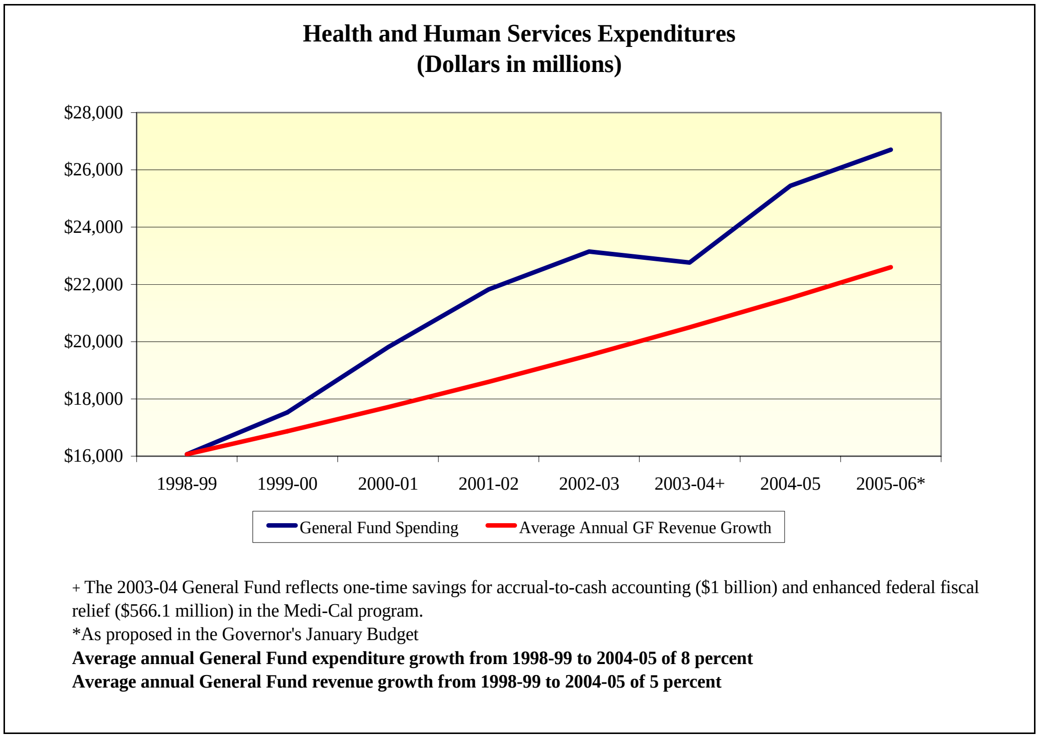
- $195.5 million for a 3.93 percent COLA
- $136.7 million for 3 percent enrollment growth
- $31.4 million for a set-aside pending agreement by the colleges to provide accountability information requested by the Governor
- $20 million to articulate vocational coursework with K-12 schools (see Career/Technical education above)

Cal Grants Continue to Grow. The budget proposes to increase Cal Grant and other student aid funding administered by the Student Aid Commission to about $808 million in 2005-06, a $44.8 million increase over 2004-05. Over 186,000 Cal Grants will be awarded to students entitled under current statute; another 56,000 awards will be made to students who compete successfully for them. In addition:

- $35 million will be shifted from the Student Loan Operating Fund to create one-time General Fund savings;
- The maximum Cal Grant award for students attending private institutions will fall from $8,332 to $7,449, creating $7.5 million in General Fund savings; and
- $200,000 is provided to begin funding awards under the new National Guard Assumption of Loans for Education program (APLE).

Health and Human Services Overview

Chart 6



For the 2005-06 fiscal year, the Governor's Budget proposes total expenditures of $69.8 billion in combined State and federal funds for all Health and Human Services Agency (HHSA) budgets, including funding for about 32,500 State employees. Compared to the 2004 Budget Act, the Governor's Budget proposes to increase the amount of General Fund budgeted for HHSA in 2004-05 by $900 million from $24.6 billion (the 2004 Budget Act amount) to $25.5 billion. For fiscal year 2005-06, the Governor's Budget total General Fund expenditures for all HHSA budgets are projected to be $26.7 billion, which represents ***an increase of $2.1 billion*** or ***8.5 percent*** over the 2004 Budget Act amount. According to the Administration, this level of funding includes $1.2 billion of General Fund savings from a variety of policy-based decisions, but the spending growth still exceeds the State's 2005-06 revenue growth of 6.8 percent.

Health and Human Services expenditures account for 31.2 percent of total General Fund expenditures. For purposes of comparison, Health Human Services General Fund expenditures constituted 32.3 percent of total General Fund expenditures in the 2004 Budget Act. The Administration indicates that it is committed to maintaining access to health and human services programs while controlling costs; however, to the extent the Governor's Budget proposes to increase spending at a rate that exceeds revenue growth it is does not appear that goal has been realized.

This section includes General Fund expenditure growth charts for some of the fastest growing health and human service programs. Please note that ***average annual General Fund revenue growth has been 5 percent from 1998-99 through 2004-05***. Therefore, the spending growth of these programs has contributed to the current State structural deficit.

Health

Governor's Health Initiatives
The Governor's Budget includes several new initiatives in the health program area that address the objective of preventing obesity, expanding the availability of affordable prescription drugs, and increasing enrollment and retention of uninsured children in Medi-Cal and the Healthy Families Program.

- **California Obesity Initiative.** The budget includes $6 million General Fund to implement an obesity prevention program. The plan would allow the Department of Health Services (DHS) to provide leadership in preventing obesity by promoting healthy eating, regular exercise, and responsible choices. We agree that obesity has become a nationwide epidemic and a public health threat. Many diseases such as heart disease, diabetes, arthritis, and some types of cancer are related to obesity. Consumers spend about $30 billion per year trying to lose weight or prevent weight gain. This figure includes spending on diet sodas, diet foods, artificially sweetened products, appetite suppressants, diet books, videos and cassettes, medically supervised and commercial programs, and fitness clubs. The Governor's Budget proposes $1.2 billion and 1,307 State employees for DHS Public and Environmental Health. However, it is not clear what DHS will do with the additional $6 million and 2.0 new State employees to turn the tide on obesity. Some would say that this augmentation is either unnecessary or inadequate. The details are not yet available, but the framework indicates that the Administration would like to do the following:

    - Support healthy school environments by improving the nutrition of the food and drinks, and increasing physical activity.
    - Increase access to obesity prevention and intervention services through health insurance programs.
    - Support local efforts to plan and design healthy communities.
    - Implement workplace changes that increase physical activity and healthy eating.
    - Recognize obesity as a statewide priority through education, outreach, and a Governor's Summit.
    - Support Medi-Cal managed care efforts to increase obesity screening and counseling, and referral for treatment for overweight children.

- **California Rx (Cal Rx) Prescription Drugs for the Uninsured.** The Governor's Budget proposes $4 million General Fund and 2.0 new positions to implement the Cal Rx Program, which will employ the "Single Point of Entry" approach presently utilized by the Healthy Families Program for application processing. The details of the proposal are still vague, but the Administration indicates that uninsured families and individuals whose income is below

300 percent of the federal poverty level ($27,936 for individuals and $56,568 for a family of four) will have access to a Web-based clearinghouse that will allow access free and reduced price drug assistance programs already offered by pharmaceutical manufacturers. Those that do not qualify for a free drug program will be able to save up to 40 percent off retail price. These discounts are intended to be competitive with Canadian drug websites. The Administration expects more than 4 million Californians will be eligible for Cal Rx.

Access to affordable prescription drugs is an issue of national scope and importance. It may be prudent to ***let the federal government take the lead*** on developing remedies for this problem before calling upon California to create a potentially costly new program and expanding the State bureaucracy.

- **Expand Health Insurance Coverage for Children.** The Governor's Budget includes a series of proposals that it believes will increase enrollment and retention of uninsured children eligible for Medi-Cal and the Healthy Families Program (HFP). Unfortunately, there is little evidence to support the efficacy of these proposals in terms of ensuring that more eligible children get enrolled in the appropriate program. There is little doubt, however, that these efforts will result in increased administrative costs to the State for Medi-Cal and Single Point of Entry application processing costs. The proposals include the following:
  - ***Restore HFP/Medi-Cal Application Assistance Funding*** **($5.9 million GF)** – These new funds will re-establish the Certified Application Assistance (CAA) program that provides payment of $50 for a new application and $25 for an annual eligibility review to individuals and organizations that help potential eligibles fill out the application forms. Both advocates and the Managed Risk Medical Insurance Board (the State agency that administers Healthy Families) have cited the lack of outreach and application assistance funding as the primary reason enrollment in HFP as leveled off. However, there are no studies that support the efficacy of past outreach efforts. Additionally, it is not clear that the CAA payment is contingent upon an actual enrollment occurring or even a completed application being submitted. The Administration anticipates that over 200,000 Medi-Cal and 60,000 HFP applicants will be served. They also believe an additional 15,000 children will be added to HFP in 2005-06.
  - ***County Performance Standards for HFP Bridge*** **($2.1 million GF)** –Currently, a child that becomes ineligible for Medi-Cal as result of their age or an increase in family income is given one month of free full scope Medi-Cal coverage to allow time to apply for the Healthy Families program. This is known as the "Medi-Cal to HFP Bridge". Counties are required to forward applications to HFP when children are eligible, however it is not clear what these performance standards are or who will enforce them and what the penalty for non-compliance might be. The Administration expects that the new standards will increase the number of referrals to HFP by 30,000 annually, and that 10,000 children will be added to HFP.
  - ***Assistance for County Health Initiatives*** **($5.9 million GF)** – The First 5 California Children and Families Commission will provide the State's 35 percent match to help fund 3.0 positions for MRMIB to provide technical assistance to counties that establish local initiatives to provide low cost health coverage to children that are not eligible for Medi-Cal or HFP. These new staff will also develop a Healthy Families buy-in option that allows counties to transfer funds to the State and

have their children enroll in HFP. It is important to understand that many of these local health initiatives are designed to serve children in families with incomes beyond that currently allowed in HFP and undocumented immigrants that are not eligible for Medi-Cal or HFP.

- ***Revised Joint HFP/Medi Cal Application*** **($3 million GF)** – The Administration wants to update the current 4-page joint application, which was developed about five years ago through a rather lengthy process that involved significant State resources and the use of focus groups. Apparently, the revisions are intended to improve the layout and make it easier to complete, thereby resulting in increased enrollment.

Department of Health Services

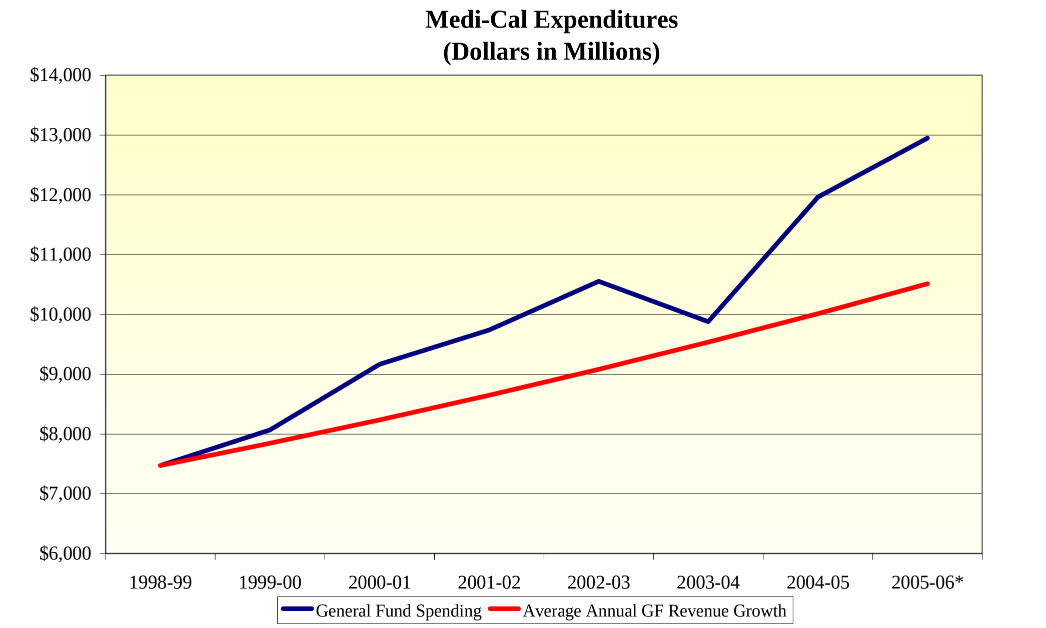
The Governor proposes a variety of policy adjustments for the Department of Health Services (DHS) that result in a $277.7 million General Fund savings; however, it appears that only $12.8 million (less than 5 percent) of these savings are achieved by actual program cuts. The remaining 95 percent of the savings is achieved through fund shifts, fund transfers, and cost avoidance proposals.

For 2005-06, the budget proposes a net increase in spending for DHS of $281 million (less than 1 percent) from all fund sources. However, State General Fund spending is proposed to ***increase by $1.02 billion*** (over 8 percent). While funding for State Operations is proposed to decrease by a total of $19 million in 2005-06, the Budget proposes a net increase of 177.7 State employees.

Medi-Cal

For 2005-06, Medi-Cal spending is projected to be $33.8 billion ($12.9 billion General Fund), which represents an increase in General Fund spending of $981.7 million or 8.2 percent above the revised 2004-05 amount, and ***$1.3 billion General Fund (11.2 percent) above the 2004 Budget Act***. This level of expenditure growth is well above the 2005-06 State revenue growth of 6.8 percent and is above the per capita U.S. medical expenditures inflator of 6.7 percent (refer to Chart 7 below).

Chart 7



*As proposed in the Governor's January Budget
Average annual General Fund expenditure growth from 1998-99 to 2004-05 of 10 percent
Average annual General Fund revenue growth from 1998-99 to 2004-05 of 5 percent

Currently, about one in six Californians qualify for Medi-Cal. The Medi-Cal caseload is expected to increase by 2.7 percent in 2005-06 to 6.8 million eligibles. This is slightly less than the expected population growth of 3.3 percent. According to the most recent survey, ***California provides more optional Medi-Cal services than any other state in the nation except Wisconsin*** (and is tied with Minnesota), and also provides more comprehensive benefits than most employer-funded health care programs. Further, Medi-Cal not only covers all federally required Medicaid populations, but also ***covers more expansion Medicaid populations than any other state in the nation.*** By percentage of state population California's Medi-Cal program (at 18.2 percent) serves more state residents than any other state except New York. These policy choices have resulted in billions of dollars of additional costs for California's Medi-Cal program. However, California continues to have one of the lowest average cost-per-recipient rates ($4,605 as opposed to the national average of $5,869). This is largely due to a high level of drug rebates from manufacturers and the fact that California does not provide adequate reimbursement to Medi-Cal providers, which results in a cost shift to other payers and higher insurance premiums for Californians not covered by Medi-Cal.

A variety of Medi-Cal Program expansions that have added 1.2 million new recipients over the past five years has also put tremendous fiscal pressure on this State. The General Fund cost of these expansions was $158 million in the first year of implementation, but General Fund costs are expected to reach $1.2 billion in fiscal year 2005-06, a 659.5-percent increase.

- **Medi-Cal Program Redesign**. The Governor proposes several major changes to the structure of the Medi-Cal program that are intended to increase efficiencies, improve health care, and better control program costs. Although certain components of the redesign will result in major new costs, the Administration believes these costs will be more than offset by other component savings. Therefore, the budget reflects a net savings of $12.3 million General Fund for 2005-06, which is expected to grow to $136.6 million by 2008-09. Specific components of the redesign include the following:

- ***Expansion of Medi-Cal Managed Care*** **($3.4 million GF)** - This proposal expands the use of managed care for families and children into as many as 13 additional counties (i.e., El Dorado, Imperial, Kings, Lake, Madera, Marin, Mendocino, Merced, San Benito, San Luis Obispo, Sonoma, Placer and Ventura counties) and requires new participants who are aged, blind, and disabled to enroll in managed care plans. The Administration anticipates a phased-in process that will begin in January 2007. In addition, Medi-Cal Acute and Long Term Care Integration plans will be established in three counties (i.e., Contra Costa, Orange and San Diego) to provide integrated Medi-Cal and Medicare services to seniors and the disabled. The General Fund cost of this proposal is expected to increase to over $50 million by 2007-08, but savings in excess of $85 million are anticipated to begin by 2008-09.
- ***Stabilize Safety Net Hospitals*** **($686,000 GF)** – The Administration has developed a new hospital financing structure that may provide stable and increasing federal funds for California's safety net hospitals. The details of this proposal remain unclear, but approximately 240 hospitals that contract with Medi-Cal or receive disproportionate share hospital payments will be affected and they are very concerned about this new financing structure. The potential short and long term benefits or harm associated with this proposal are difficult to determine, and will largely be subject to decisions made by the federal Centers for Medicare and Medicaid Studies (CMMS). No savings are anticipated, but the Administration forecast ongoing annual General Fund costs of $686,000.
- ***New Limits for Medi-Cal Adult Dental Benefit*** **(-$24.8 million GF)** – Aligns the Medi-Cal dental benefit package with that of private sector employer-based dental packages by establishing an annual limit of $1,000 for adult dental services. According to the Administration, most dental needs of adults will still be covered under the limit, including dentures and emergency services. Most commercial dental plans (including those offered to State employees) provide annual limits on dental benefits. Annual General Fund savings in excess of $25 million are anticipated to begin in 2006-07.
- ***Beneficiary Cost Sharing*** **($6.8 million GF)** – This proposal will establish premiums for individuals with monthly incomes above the federal poverty level ($1306 for a family of three), and for seniors and persons with disabilities with incomes above the monthly Supplemental Security Income/State Supplemental Payment ($812 for individuals and $1,437 for couples). The premiums will be $4 per month for children and $10 per month for adults. There would be a monthly maximum of $27 per family. This is intended to make Medi-Cal more like employer-based health plans and other public programs such as Healthy Families. This will also promote beneficiary responsibility and ownership of their health care. Annual General Fund savings of $22.0 million are anticipated to begin in 2007-08.
- ***Expedite Medi-Cal Eligibility for Children*** **($976,000 GF)** – The Administration proposes to allow the private entity that currently processes the joint Healthy Families/Medi-Cal applications submitted to the Single Point of Entry (SPE) to make a preliminary eligibility determination for children's Medi-Cal applications. This is significant because current practice requires the vendor, who is paid to review the

application anyway, to forward the application to a county if the child is not eligible for Healthy Families. Therefore, the current process is inherently wasteful and duplicative. This should also result in faster enrollment for the children. The Administration anticipates annual ongoing General Fund savings in excess of $7 million, but it is not yet clear if those savings are net of the potential increased caseload costs.

- ***Monitor County Performance Standards* ($612,000 GF)** – Similar to several proposals adopted last year, this would build upon existing efforts to ensure counties are meeting the required Medi-Cal eligibility determination and annual redetermination performance standards. Currently, counties self report their level of compliance, but there is no verification by the State. While this is an activity that DHS should have been performing since the inception of the program, the Administration has proposed to hire a private vendor monitor county compliance with the long standing federal and recently adopted state performance standards. No additional savings are anticipated as a result of these efforts since other similar and related efforts such as the Mid-Year Status Reporting already appear to be flattening caseload. The Administration does anticipate increased annual General Fund costs of about $2.7 million to secure a vendor beginning in 2006-07.

➢ **Spending Reduction Proposals**. The budget includes the following savings:

- ***Additional Pharmacy Rebates* ($20 million GF)** – The Governor's Budget includes these savings, which are the result of negotiated rebates from pharmaceutical manufacturers related to heartburn medication (proton pump inhibitors).
- ***Aids Drug Assistance Program Rebates* ($8 million GF)** – These savings are the result of higher than anticipated collections from drug manufacturer rebates.
- ***Eliminate General Fund for Office of Binational Border Health* ($694,000 GF)** – Elimination of these funds will have little impact on communication between California and Mexican health officials regarding disease prevention.
- ***New Federal Funds for Prenatal Care* ($191 million GF)** – The Governor's Budget anticipates federal matching funds will be made available for prenatal care for Medi-Cal prenatal services for pregnant undocumented immigrants.
- ***Third Party Liability Recoveries* ($19.7 million GF)** – The budget provides $1.8 million General Fund for DHS to hire 76.5 new State employees that will increase recovery of Medi-Cal costs from liable third parties such as insurance companies, worker's compensation insurers, and the estates of deceased beneficiaries. Net savings is $19.7 million.

Public Health

Expenditures for all public health programs and state support are projected to be $3.5 billion ($703 million General Fund) in 2005-06. This represents a **General Fund increase of $53.5 million (8.3 percent)** above the revised 2004-05 level, which exceeds the 2005-06 State revenue growth of 6.8 percent and the per capita U.S. medical expenditures inflator of 6.7 percent.

➢ **HIV/AIDS Treatment and Prevention.** The Budget proposes $381 million ($159.5 million General Fund) for the Office of AIDS' Treatment and Prevention program. This is an increase of $20.1 million, or 5.6 percent, above the revised 2004-05 budget amount.

Almost 70 percent of total HIV/AIDS program expenditures ($263.6 million) are budgeted for the AIDS Drug Assistance Program (ADAP). It is estimated that ADAP will serve 30,446 clients in fiscal year 2005-06. Although there is no legal entitlement to these services, the ADAP program has historically received full funding for all caseload growth. The Administration has not proposed any reforms to control cost growth in ADAP.

- **Proposition 99 Expenditures.** The Budget projects that total resources available for fiscal year 2005-06 will be $9 million below the 2004 Budget Act. The Governor proposes a total expenditure of $315 million for all Proposition 99 supported programs. ***The Administration expects to save about $71.4 million in 2004-05 and $80.7 million in 2005-06 by utilizing available federal funding for prenatal care in the Access for Infants and Mothers Program (AIM).*** The Governor proposes to then use the Proposition 99 revenue savings to offset the General Fund costs of the following health programs (net GF savings of $39.2 in 2004-05 and $15.3 million in 2005-06):

  - Department of Mental Health hospital services ($9.8 million in 2004-05 and $13.6 million in 2005-06).
  - Medi-Cal Recent Immigrants Program ($54.4 million in 2004-05 and $32.8 million in 2005-06).
  - Expanded Access to Primary Care (EAPC) clinics ($10 million in 2005-06).

  Some legal questions may arise about the ability to use these Proposition 99 revenues in place of General Fund as it raises issues of supplantation, which is not allowed under Proposition 99.

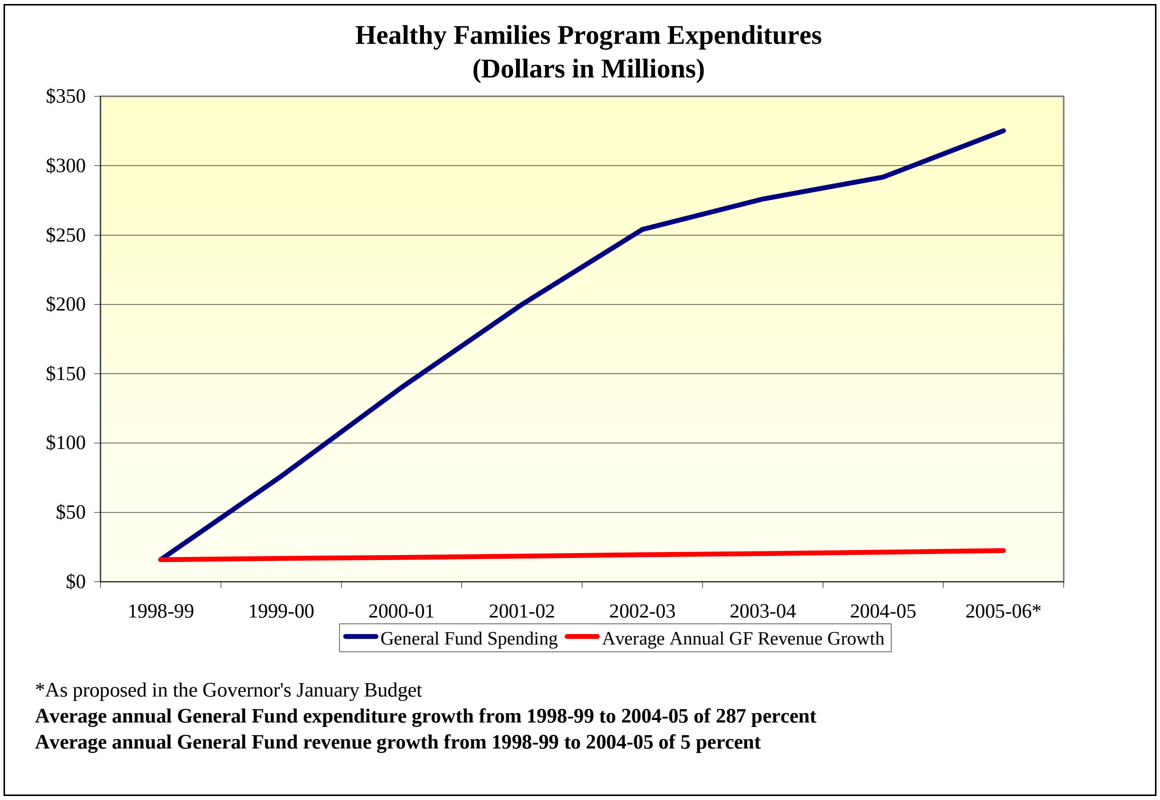
- **Newborn Screening Program Expansion** - The Governor's Budget includes $15 million Genetic Disease Testing Fund and 2.8 positions to expand the Newborn Screening Program. DHS will screen newborns for an additional 37 treatable genetic diseases using Tandem Mass Spectrometry technology. DHS estimates that approximately 561,000 children will be evaluated and 83 children will be diagnosed and receive treatment annually.

  The ability of DHS to implement this program expansion in a cost effective and timely manner is open to question. This is important because the expansion is supported by a fee increase of $18 (from the current $60 to $78) levied on hospitals and health plans. This fee increase will also result in increased Medi-Cal costs since Medi-Cal pays the fee for Medi-Cal beneficiaries.

Managed Risk Medical Insurance Board. The Governor's Budget proposes $1.05 billion ($355.9 million General Fund) and 92.0 positions for the Managed Risk Medical Insurance Board (MRMIB). This represents a General Fund increase of $29 million or 8.9 percent and 33.5 positions ***(a staffing increase of nearly 50 percent)*** above the 2004 Budget Act.

Healthy Families Program

Chart 8



As shown in Chart 8 above, expenditures for the Healthy Families Program (HFP) are projected to grow from $806.8 million ($291.9 million General Fund) in 2004-05 to $894.9 million ($325.2 million General Fund) in 2005-06, an increase of $33.3 million General Fund, or 11.4 percent. At the same time, the Administration estimates that enrollment will grow from 713,900 by year-end 2004-05 to 779,400 in 2005-06 for a total increase of 65,500 children. These are well above the expected population growth of 3.3 percent, and the 2005-06 State revenue growth of 6.8 percent or the per capita U.S. medical expenditures inflator of 6.7 percent.

This caseload estimate may be highly optimistic since HFP enrollments have actually leveled off. HFP caseload grew by only 1,600 children from 2002-03 to 2003-04, and recent data indicates that ***the number of subscribers dropped 6,802 between January and August 2004*** to 679,643. Many advocates (and the department) insist the elimination of outreach and application assistance funds is to blame, but many non-State resources such as the California Health Care Foundation continued to provide funds for such activities. As discussed earlier in the ***Governor's Initiatives*** section of this analysis, the Administration is investing considerable time and resources to expand enrollment, but it may simply be the case that the program has reached its tipping point.

Access for Infants and Mothers. Access for Infants and Mothers (AIM) program expenditures for are anticipated to decrease from $123.2 million ($32.8 million General Fund) in 2004-05 to $99.8 million ($28.5 million General Fund) in 2005-06, for a total decrease of

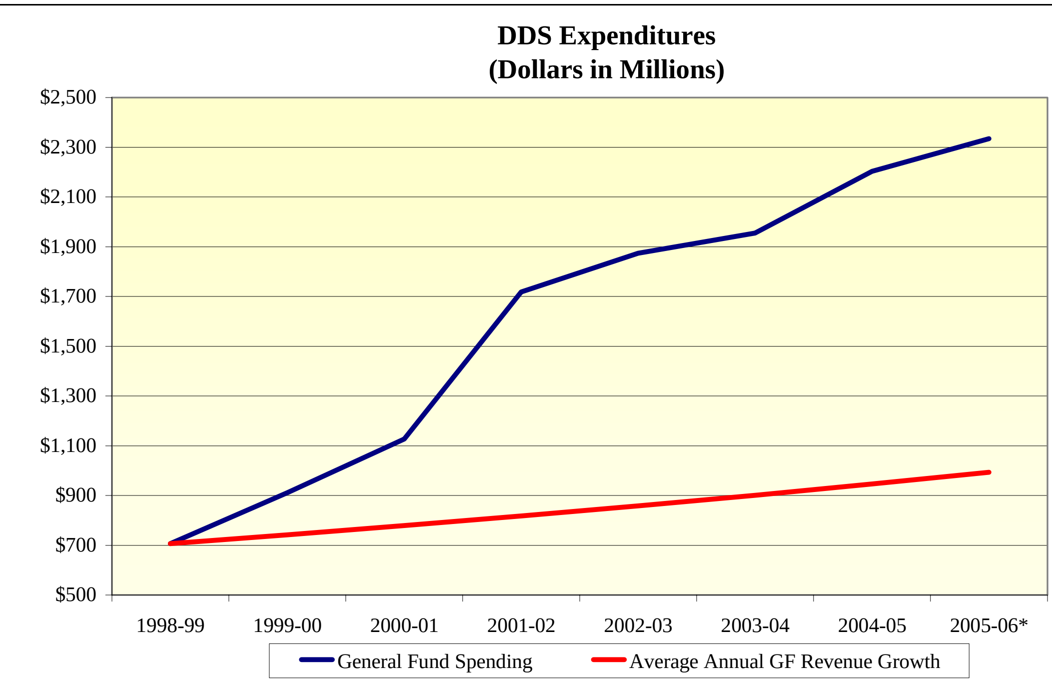
$23.4 million, or 19 percent. The decrease in funding for 2005-06 is primarily the result of the enrollment of infants born to AIM mothers directly into HFP, which began in 2004-05 as a way to draw down federal matching funds instead of maintaining these infants in the State-only funded AIM program. The Administration indicates enrollment will decrease nearly 88 percent from an average monthly enrollment of 5,930 in 2004-05 to less than 800 in 2005-06.

AIM provides low-cost, comprehensive health insurance coverage to uninsured pregnant women with family incomes between 200 percent and 300 percent of the federal poverty level. This coverage extends from pregnancy to 60 days postpartum, and covers infants up to two years of age. Enrollees pay 1.5 percent of their adjusted annual household income after income deductions, and there are no co-payments or premiums. As discussed in the ***Public Health Proposition 99*** section of this analysis, the Administration expects to save about $71.4 million in 2004-05 and $80.7 million in 2005-06 by utilizing available federal funding for prenatal care in the AIM Program. The Governor proposes to then use the Proposition 99 revenue savings to offset the General Fund costs of other specified health programs. Enrollment of women is projected to increase from 8,500 in 2004-05 to 9,350 in 2005-06 for a total increase of 850 women, or 10 percent.

Department of Developmental Services

The Governor's Budget includes $3.7 billion ($2.3 billion General Fund), a net increase of $166.4 million ($129.9 million General Fund or 5.9 percent) from the revised 2004-05 Budget. This is slightly less than the State's revenue growth rate of 6.8 percent. (See Chart 9 below.)

Chart 9



*As proposed in the Governor's January Budget
Average annual General Fund expenditure growth from 1998-99 to 2004-05 of 35 percent
Average annual General Fund revenue growth from 1998-99 to 2004-05 of 5 percent

- **Regional Centers.** The budget proposes $3 billion ($1.9 billion General Fund) to support the Regional Centers in fiscal year 2005-06. This reflects an increase of $187.6 million ($143.1 million General Fund) over the revised current-year estimates. Since fiscal year 1998-99, the program has grown by $1.6 billion General Fund or 230 percent. The budget does not cap caseload or eliminate services. The regional center community population is projected to increase by 8,765 consumers to 208,020 in 2005-06. The Governor has included two new proposals intended to improve service and contain costs:

  1. ***Self-Directed Services* (-$2.2 million GF)** – Regional Centers are contracted by DDS to purchase and coordinate services mandated under the Lanterman Act for persons with developmental disabilities. The DDS will apply for a federal Independence Plus waiver to expand Self-Directed Services Program to five additional regional centers. This will allow consumers to purchase services and support mechanisms through an individual budget account based upon their needs. This will improve the State's compliance with its Olmstead plan. The Governor's Budget includes $1.2 million General Fund to implement these changes.

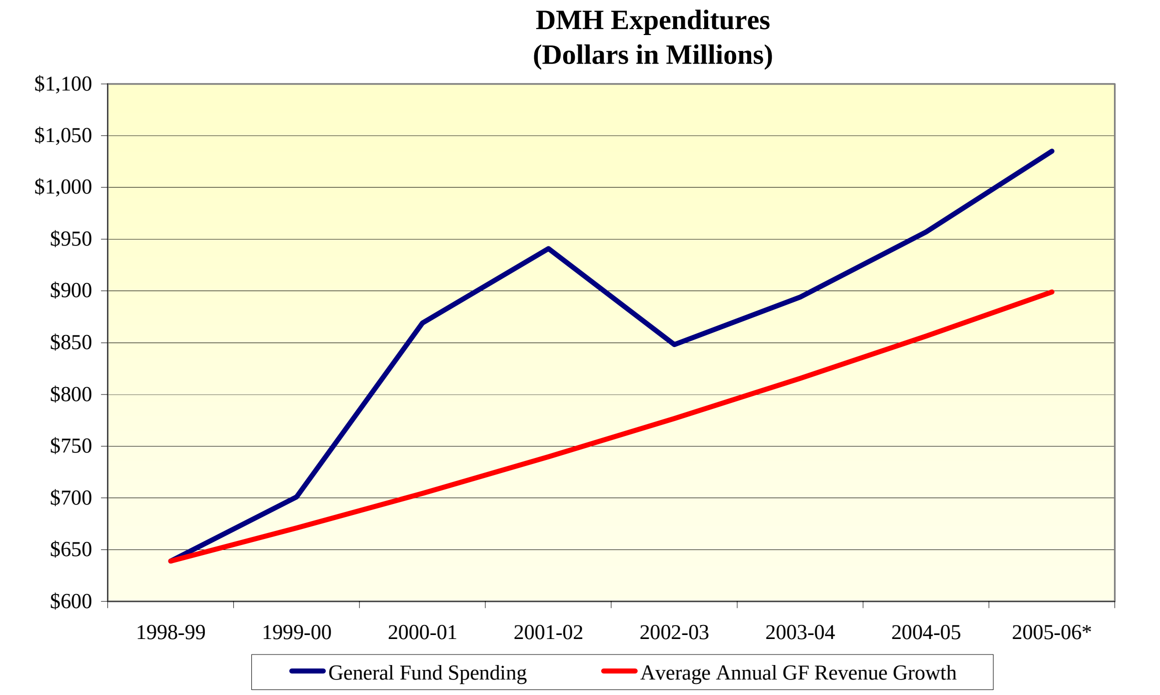
  2. ***Long-Term Cost Containment*** (-$10.5 million GF) – The details are not yet clear, but the Administration proposes to have Regional Centers use "sensible" guidelines when developing individual service plans for consumers, purchasing services, and ensuring that consumers have support when developing their own self-directed treatment options. The Governor's Budget includes $6.2 million General Fund to implement these changes.

- **Developmental Centers.** The Governor's Budget proposes $699.2 million ($373.1 million General Fund) to operate the Developmental Centers. This represents a decrease of $22.3 million ($13.9 million General Fund or 3.7 percent) from the revised 2004-05 Budget. In addition the budget includes a reduction of 402.0 positions, which is the result of an anticipated decline in the developmental center population of 236 consumers in 2005-06 (from 3,307 to 3,071). Additionally, the Administration is moving forward with plans to close a developmental center, which will actually result in higher costs:

  - ***Agnews Closure* ($27.1 million GF)** – The closure plan will transition residents to safe and stable homes in the community and ensure ongoing quality of care. This goal of keeping clients out of developmental centers and in the community is also consistent with California's Olmstead Plan.

Department of Mental Health

Chart 10



*As proposed in the Governor's January Budget
Average annual General Fund expenditure growth from 1998-99 to 2004-05 of 8 percent
Average annual General Fund revenue growth from 1998-99 to 2004-05 of 5 percent

The Budget includes $2.7 billion ($1.0 billion General Fund) for state hospitals and community mental health programs, which is a net increase of $171.8 million ($78.1 million General Fund or 8.2 percent) above the revised 2004-05 Budget. As shown in Chart 10 above, this exceeds 2005-06 State revenue growth of 6.8 percent and the per capita U.S. medical expenditures inflator of 6.7 percent. The budget also includes an additional 601.7 positions (a total of 9,346.5), which is an increase of 6.9 percent. ***Since 1998-99 the Department of Mental Health's General Fund expenditures have increased by $369 million (62 percent).***

Proposition 63, the Mental Health Services Act (MHSA). Although this new ballot initiative went into effect on January 1, 2005 there is not yet much to report. DMH has convened several stakeholder workgroups to figure out how to dole out the money, and will take the lead as the process moves forward.

State Hospitals. General Fund expenditures have **increased by $386 million (136 percent)** between fiscal year 1998-99 and the proposed 2005-06 Governor's Budget, which provides $837.5 million ($670.1 million General Fund). The patient population is expected to reach a total of 5,454 in 2005-06. The budget reflects savings from two changes in the way Sexually Violent Predators (SVPs) are treated and housed:

- ***Restructure SVP Treatment Protocols*** (-$6 million GF) – Because of the varying treatment, custody, and supervision needs of SVPs, some of whom may refuse treatment entirely, the Administration proposes to better align supervision and treatment with needs, and to only provide 24-hour nursing care when necessary.

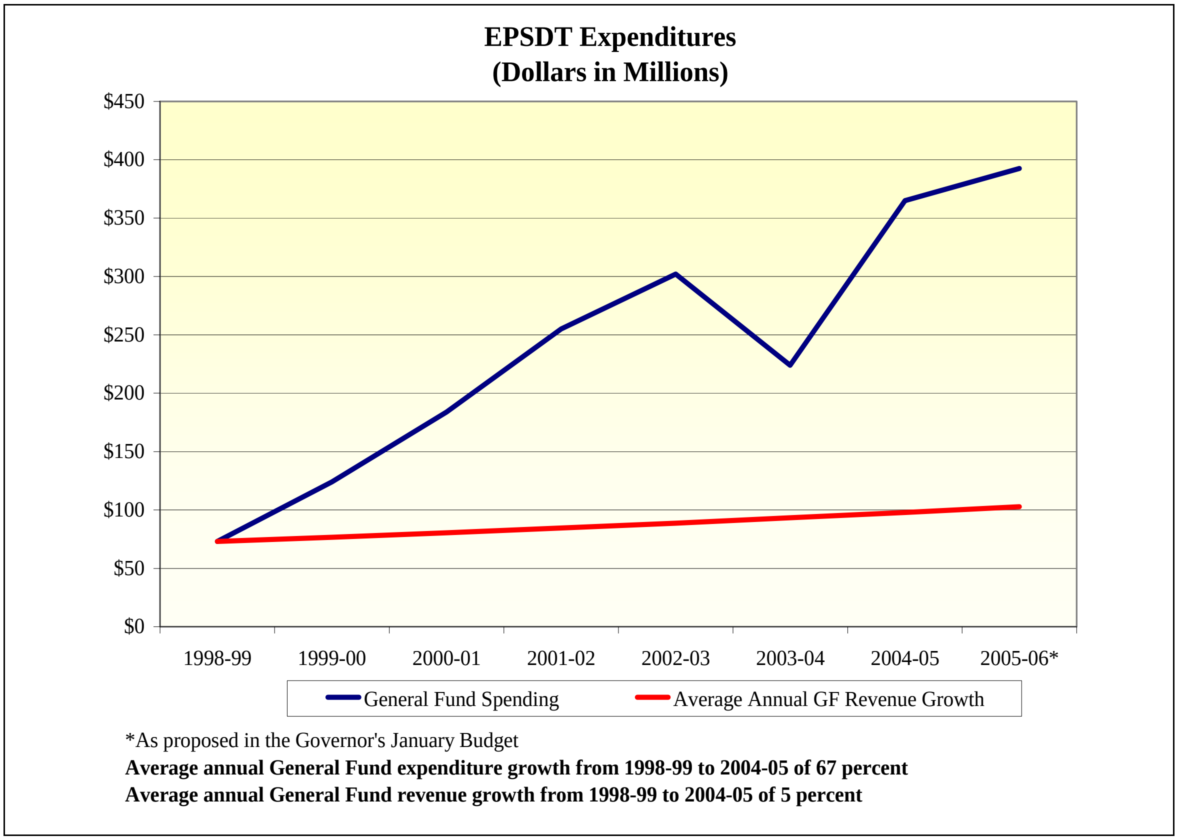
- ***Precommitment SVPs to Remain in Local Custody* (-$9.2 million GF)** – Requires all precommitted SVPs to remain in local custody until the courts commit them as SVPs. Precommitted SVPs residing at Atascadero State Hospital awaiting trial would be returned to local custody under this proposal.

Both of these proposals were submitted by the Administration last year, but they did not make it out of policy committee. In fact, the Assembly Democrats promised to "fast-track" the bills in order to address concerns that the savings would not be captured if these items were not adopted in the budget. However, this never occurred, and the Administration has resubmitted them.

- **Activation of Coalinga State Hospital**. Beginning in 2000, the State initiated steps to construct a new 1,500-bed secure mental health treatment facility to provide DMH with additional capacity to treat patients involuntarily committed under the SVP law. However, the opening of the facility has been continually delayed in order to save money in the budget. The 2004 Budget Act delayed activation of CSH from August 2005 to September 2005. It appears that this new facility will finally be activated effective September 2005 as anticipated. The hospital will treat all SVP patients currently housed at Atascadero State Hospital and inmates referred from the Department of Corrections. $74.2 million General Fund and 708.7 additional staff are provided for by the budget to treat 683 patients. Activation of the remaining 800 beds will continue over the next four fiscal years.

Early Periodic Screening, Diagnosis, and Treatment (EPSDT).

The Budget proposes $801.2 million ($392.5 million General Fund) to maintain the EPSDT entitlement, and no new reforms are proposed. Not including the accrual-to-cash accounting change*, **EPSDT costs have increased by $320 million General Fund since 1998-99, which represents an increase of 437 percent***. (See Chart 11 below).



Human Services

Welfare-to-Work
The Budget provides $6.7 billion for California Work Opportunity and Responsibility to Kids (CalWORKS) programs, including $4.9 billion for direct programs, $1.5 billion for other programs, and $196.4 million for a reserve to mitigate the potential for additional federal requirements and penalties. The funding consists of $3.6 billion in federal funds from the federal Temporary Assistance to Needy Families (TANF) grant, $2.5 billion State General Fund, $315.6 million federal TANF funds available from previous years, $154.5 million from other county sources, and $40.1 million in Employment Training Panel funds.

The Budget indicates that caseload growth is continuing to flatten after many consecutive years of decline. Estimated CalWORKS caseload for 2005-06 is 473,000 cases, a decrease of 22,000 from 2004-05*. However, as shown in the table below, California has not experienced the same level of caseload decrease of other large states*:

Comparison of Change in Caseload Receiving Temporary Assistance for Needy Families for the Ten Most Populous States					
	Jan 1995	**Jan 1998**	**March 2004**	**% Change Jan 95- Mar 04**	**% Change Jan 98-Mar-04**
Illinois	240,013	175,445	35,534	-85.2%	-79.7%
Florida	241,193	121,006	55,728	-76.9%	-53.9%
New York	461,006	347,536	149,542	-67.6%	-57.0%
Ohio	232,574	147,093	84,852	-63.5%	-42.3%
Texas	279,911	158,252	103,262	-63.1%	-34.7%
New Jersey	120,099	89,030	44,500	-62.9%	-50.0%
Georgia	141,284	84,318	53,685	-62.0%	-36.3%
Michigan	207,089	128,892	80,307	-61.2%	-37.7%
Pennsylvania	208,899	140,446	87,111	-58.3%	-38.0%
California	925,585	727,695	458,279	-50.5%	-37.0%

The Budget proposes reforms that reduce program costs and attempt to improve county performance while placing a greater emphasis on work participation and personal responsibility.

- **Reduce CalWORKs Grants.** CalWORKs grant levels are currently highest among the ten most populous states. This proposal will reduce grants by 6.5 percent for savings of $208.5 million. As reflected in the next table, even with this reduction, California's grant levels will be the second highest of the ten most populous states.

Comparison of Temporary Assistance for Needy Families Maximum Payment for the Ten Most Populous States	
State	**Monthly Grant for Family of Three**
New York	$691
California[1]	676
Michigan	489
New Jersey	424
Pennsylvania	421
Illinois[2]	383
Ohio	373
Florida	303
Georgia	280
Texas	223

1 California grant amount reflects the 6.5 percent reduction in 2005-06, while the grant amounts for all other states are as of January 1, 2005.

2 Illinois has three grant amounts. Amounts shown are the mid level.

- **Eliminate the Statutory Requirement to Provide a Cost-of-Living Adjustment.** This proposal will eliminate the statutory requirement to provide an automatic annual grant COLA, which is required regardless of whether sufficient resources are available to support such an increase. This will result in savings of $163.8 million in 2005-06 and annually thereafter.

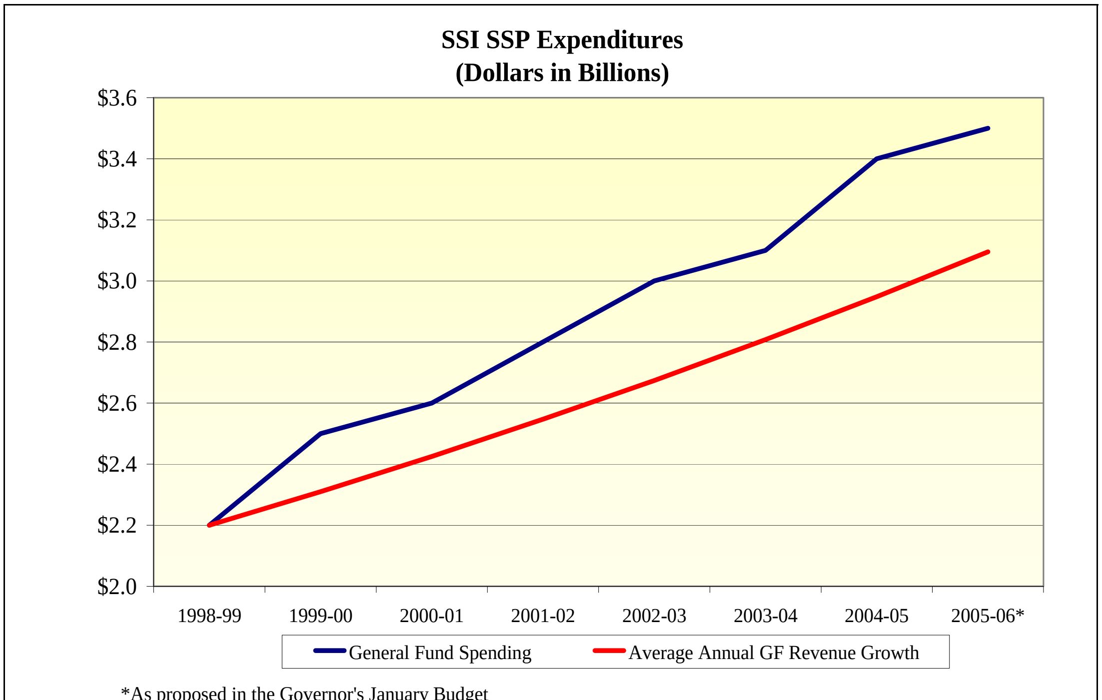
- **Reduce the Income Disregard.** This proposal will allow CalWORKs families to keep $200 and 40 percent of remaining earned income rather than the current $225 and 50 percent of remaining earned income. This proposal will result in savings of $79.5 million in 2005-06 and $109.3 million annually thereafter. California's earned income disregard policy will continue to be one of the most generous among the large states.

- **Pay for Performance.** The Administration proposes to implement a new incentive system that bases a portion of the counties' single allocation for administration and employment services on specific outcomes of CalWORKs clients in each county. According to the Administration, the Pay for Performance model is designed to ensure that counties invest resources in activities that are most effective and efficient in achieving the desired outcomes, such as higher work participation rates among CalWORKs recipients. This proposal is estimated to result in savings of $22.2 million in 2005-06.

- **Strengthen Work Requirements.** Reforms included in the 2004 Budget Act to strengthen the work focus of the CalWORKs program will be fully implemented in 2005-06 and are expected to result in a cost avoidance of $8.5 million in 2005-06. These reforms require recipients to be enrolled in welfare-to-work activities sooner after aid is approved and require that more hours be dedicated to direct work activities. The Administration proposes to build on these reforms after completing an evaluation of current CalWORKs sanction policies. Although these reforms are not explicitly described in the Budget, savings resulting from providing further incentives to work are targeted at $12 million in 2005-06.

Supplemental Security Income/State Supplementary Payment (SSI/SSP)

Chart 12



*As proposed in the Governor's January Budget
Average annual General Fund expenditure growth from 1998-99 to 2004-05 of 9 percent
Average annual General Fund revenue growth from 1998-99 to 2004-05 of 5 percent

The Budget proposes $3.5 billion for SSI/SSP in 2005-06, a 1.1 percent increase from the 2004 Budget Act (see Chart 12 above). The Budget estimates 1.2 million cases in 2005-06, an increase of 2.3 percent over 2004-05. The caseload consists of 68 percent disabled, 30 percent aged, and 2 percent blind persons.

Suspension of Cost of Living Increases. The Budget proposes to suspend the January 2006 State COLA of 4.6 percent for SSI/SSP grants and withhold the January 2006 federal COLA of 2.3 percent for General Fund savings of $258.9 million in 2005-06 and $517.8 million annually thereafter. However, it is important to note that overall grant payment standards will increase on April 1, 2005 to $812 for an individual and $1,437 for a couple, based on a 2.7 percent federal COLA and a 2.75 percent State COLA passed through in the current year. As shown in the table below, California provides the highest level of cash grants to SSI/SSP recipients among the ten most populous states in 2004-05.

Comparison of the 2004-05 SSI/SSP Maximum Payments for the Ten Most Populous States

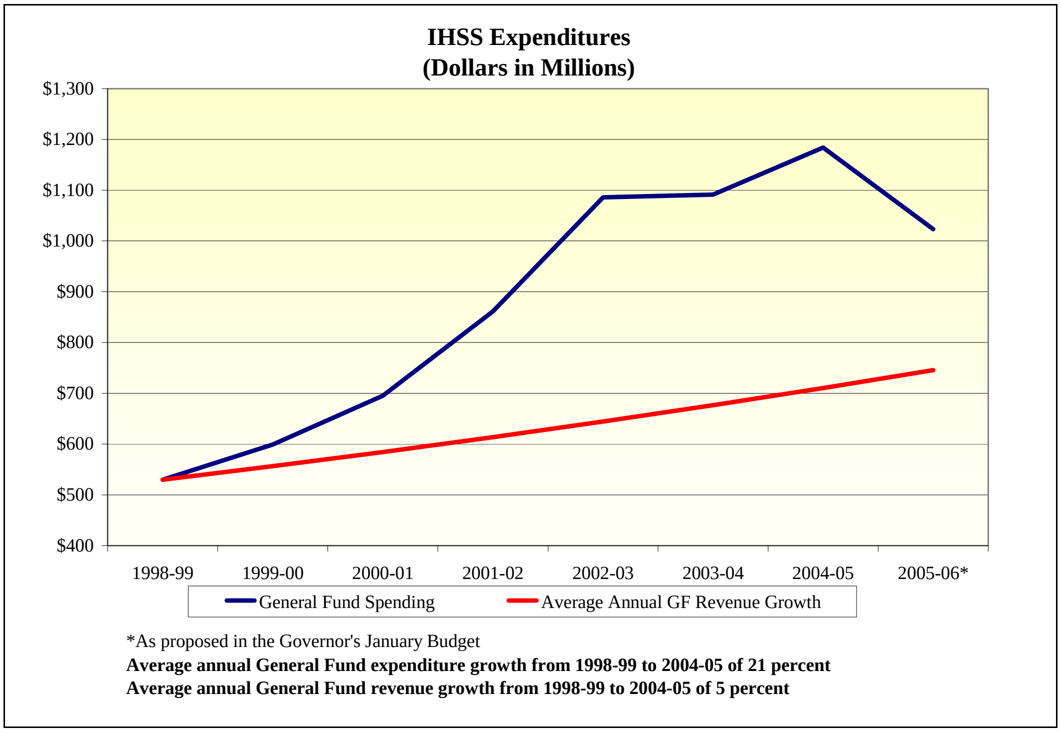
	Aged and Disabled		Blind	
State	**Individual**	**Couples**	**Individuals**	**Couples**
California	$812	$1,437	$877	$1,664
New York	666	973	666	973
New Jersey	610	894	610	894
Pennsylvania	606	913	606	913
Michigan	593	897	593	897
Florida	579	869	579	869
Georgia	579	869	579	869
Texas	579	869	579	869
Illinois	579	869	579	869
Ohio	579	869	579	869

In-Home Supportive Services (IHSS)

As shown in Chart 13 below, the Budget proposes $1 billion General Fund for the IHSS program in 2005-06, a decrease of 11.6 percent from the 2004 Budget Act. The caseload is estimated to be 382,000 recipients in 2005-06.

- **Reduce State Funding for Wages and Benefits.** General Fund expenditures for the IHSS program grew 120 percent over the period from the 1998-89 to the 2004 Budget Act, even though the caseload grew by only 65.3 percent. According to the Administration, the primary reason for this disproportionate cost growth has been an increase in costs per case due to increases negotiated by local government entities in IHSS provider wage and benefit costs. Therefore, the Budget includes General Fund savings of $194.8 million in 2005-06 and $259.5 million annually thereafter for a proposal to reduce the State share-of-cost of provider wages and benefits and contract provider rates to the State minimum wage. Currently, the State shares up to $10.10 per hour in provider wages and benefits, and up to the Maximum Allowable Contract Rate for contract providers.

Chart 13



Child Welfare Services

The Budget provides $2 billion ($645.1 million General Fund) for services and out-of-home care for children who are either at risk of or have suffered abuse and neglect.

- **Program Improvement Plan**. In 2002, California failed 12 out of 14 outcome measures in a federal review of child welfare system programs. In 2004-05, 11 counties are implementing systematic program changes designed to improve program performance. The Budget includes an 11.5 million General Fund increase for 11 additional counties to implement these activities. In addition, the Budget proposes legislation to allow the State to pass on to counties a portion of future federal penalties associated with California being out of compliance.

Child Support Services

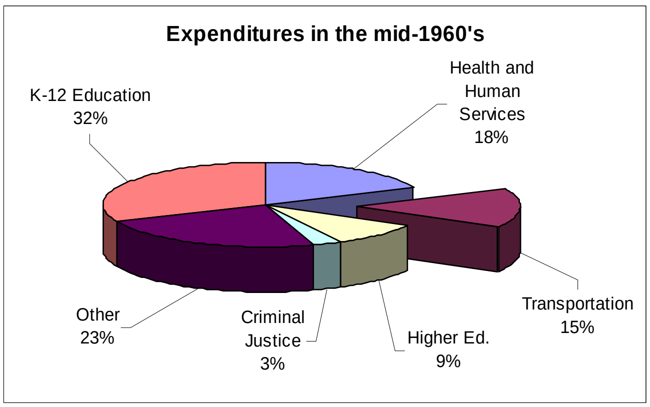
The Budget proposes $1.4 billion ($508.2 million General Fund) for child support services.

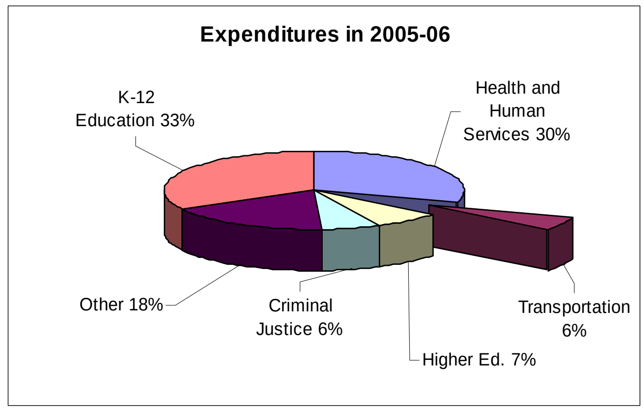
- **Automated System Penalties.** The Budget proposes $218 million General Fund in 2005-06 to pay federal penalties because the State failed to implement a single, statewide automated child support system. In 2004-05, the State negotiated a deferral of this penalty for one year. The Budget assumes payment of this past deferral in 2005-06, and also assumes that the federal government will allow the State to defer the Federal Fiscal Year 2006 penalty until 2006-07.

Transportation

Over the past several decades, the proportion of State funds (special funds plus General Fund) dedicated to transportation has been shrinking, when measured as a percentage of total State expenditures. In the mid 1960's, expenditures for transportation infrastructure and enforcement programs, including the Department of Motor Vehicles (DMV), and the California Highway Patrol (CHP), accounted for approximately 15.2 percent of total State spending. By 2000, this number had dropped to only 5.2 percent, giving way to dramatic increases in other program areas, primarily health and human services.

For fiscal year 2005-06, the Governor's Budget proposes expenditures of approximately $6.6 billion in State funds for transportation infrastructure and enforcement programs. This represents approximately 6.4 percent of total State expenditures. The table below shows the decline of State funds for transportation infrastructure and enforcement as a proportion of the total State budget, from the mid-1960's to 2005-06.





Note: When expenditures for the DMV and CHP were excluded, transportation infrastructure spending accounted for approximately 12.6 percent in the mid-1960's and 4.1 percent in 2005-06.

Proposition 42. Enacted by the voters in the March 2002 election, Proposition 42 amended the State Constitution to permanently dedicate sales taxes on gasoline for transportation projects. Specifically, the Proposition requires the transfer of gasoline sales tax revenues from the General Fund to a newly created Transportation Investment Fund (TIF). The Proposition also allows the Administration and the Legislature (if two-thirds of the membership approve) to suspend the transfer of sales tax revenues in a fiscal year in which the transfer will result in a significant negative impact on government functions funded by the General Fund.

The transfers have been suspended every year since Proposition 42 became effective. In fiscal year 2003-04, $868 million of the $1.157 billion in gasoline sales tax revenues was suspended. For 2004-05, the entire $1.243 billion is suspended, and $1.310 billion is proposed to be suspended again in 2005-06, as shown in the table below.

Proposition 42 Funds		
	(Dollars in millions)	
Fiscal year	**Amount to be Transferred**	**Amount Suspended**
2003-04	$1,157	$868
2004-05	1,243	1,243
2005-06	1,310	1,310
Total	**$3,710**	**$3,421**
92% of Prop. 42 Funds Will Have Been Suspended		

In total, $3.4 billion or approximately 92 percent of voter-approved Prop. 42 transportation funds will have been retained in the General Fund to be used for non-transportation purposes.

The Governor's Budget also includes various proposals regarding future suspensions and repayment of Prop. 42 transfers, as follows:

- Legislation is proposed to repeal the authority for suspending Prop. 42 transfers, beginning in fiscal year 2007-08. Republicans have argued that taxes imposed on gasoline sales ought to be dedicated to transportation projects to alleviate traffic congestion and repair streets and roads. This proposal would help ensure that voter-approved transportation funds are used only for transportation purposes.

- Prop. 42 suspensions that are not repaid by July 1, 2007, are to be repaid within 15 years. The amount of the repayment in any fiscal year is to be at least 1/15th of the total amount owed.

- The proposal also authorizes the issuance of bonds to be used for purposes consistent with Prop. 42. These bonds would be secured by repayments of Prop. 42 funds.

While these proposals would provide future safeguards, it does very little to help transportation funding in the present. If the 2005-06 suspension is approved, a total of $3.4 billion in Prop. 42 transportation funds will have been diverted for non-transportation purposes. And, Prop. 42 funds could still be diverted next year. Moreover, the proposed 15-year repayment term on $3.4 billion would add only 3 percent, or less than $230 million a year, to Caltran's total annual operating budget.

The Legislative Analyst reports that Californians already spend over 512,000 hours a day in traffic, at a daily cost of $11.9 million in wasted time and fuel. With the increasing growth in urban population, suspension of Prop. 42 funds will further exacerbate traffic gridlock in California.

Repayment of transportation loans from tribal gaming bonds. Between fiscal years 2001-02 and 2004-05, the General Fund borrowed a total of $3.667 billion from transportation, including $1.556 billion in loans from various transportation accounts, and $2.111 billion from the 2003-04 and 2004-05 Prop. 42 suspensions.

For 2004-05, a total of $1.397 billion is proposed to be repaid from a variety of funding sources, authorized by both the 2004 Budget Act and AB 687 related to tribal gaming compacts. Specifically, the Budget Act authorizes repayment of $183 million from a combination of General Fund and Public Transportation Account "spill-over" revenues. Also, AB 687 (Chapter 91, Statutes of 2004) proposes to repay $1.214 billion from bond proceeds secured by tribal gaming revenues.

At the time of this analysis, the timing for sale of the bonds is uncertain due to litigation that has been filed against the State. The 2005-06 budget proposes trailer legislation that would make repayment of these transportation loans contingent upon receipt of tribal gaming bonds.

The table below shows the repayment of $1.397 billion from the various funding sources, and how that repayment would be prioritized among the transportation accounts. Republicans traditionally support priority funding for the SHA and local streets and roads over TCRP and PTA, because the former fund construction and maintenance of the State's highway system and local roads, whereas the latter tend to fund projects of questionable merit and mass transit.

(Dollars in millions)	Budget Act		AB 687	Total
	General Fund	Spill-over	Gaming Bonds[a]	
State Highway Account (SHA)	$20	0	$457	$477
Traffic Congestion Relief Program (TCRP)	23	140	290	453
Public Transportation Account (PTA)	0	0	275	275
Local Streets and Roads	0	0	192	192
State Transit Assistance	0	0	0	0
Totals	**$43**	**$140**	**$1,214**	**$1,397**

[a] *AB 687 specifies the order in which the various transportation accounts will be repaid. Specifically, bond proceeds from tribal gaming revenues would first repay the SHA and the TCRP for the amounts reflected above, totaling $747 million. Then $384 million would be allocated equally between the PTA and local streets and roads, with each receiving $192 million. The remaining $83 million would go to the PTA.*

Public Transportation Account (PTA) "spill-over" funds. Current law contains an arcane formula that requires the General Fund to transfer sales tax revenues to the PTA under specified conditions. This transfer is often triggered during periods of high gasoline prices and is used to fund rail and mass transit projects. The Budget Act transfers $215.8 million in "spill-over" funds to the General Fund. This proposal would, in effect, divert monies from public transit projects to the General Fund.

High-Speed Rail. Chapter 71, Statutes of 2004 (SB 1169) delayed placing a $9.95 billion general obligation bond measure (for a high-speed rail system) before the voters, until November 2006. The Governor's Budget proposes total expenditures of $3.9 million for High-Speed Rail. This includes a one-time increase of $2.7 million for legal defense of the Environmental Impact Report, additional environmental work, and completion of a business plan. It's questionable whether the State ought to continue spending money on preliminary environmental and design work for a rail system that would cost as much as $14.7 billion, assuming a 20-year term at a financing rate of 5 percent. Furthermore, if ridership revenues are insufficient to cover the operating costs, this project could end up costing taxpayers millions of dollars in annual subsidies. The budget also proposes to eliminate the High-Speed Rail Authority and to transfer its functions to the California Transportation Commission.

No Aeronautics Account transfer to the General Fund. Revenues for the Account are derived from an excise tax on aviation and jet fuel. These funds are typically used by publicly-owned airports to maintain and improve runways. In 2002 and 2003, approximately $6 million and $4.8 million, respectively, were transferred from the Aeronautics Account to the General Fund. No Aeronautics Account funds are proposed to be transferred to the General Fund in 2005-06.

Legislation to Improve Transportation Management and Project Delivery. The Administration indicates that it will propose a comprehensive package of legislation for the 2005-06 Legislative Session, known as "GoCalifornia", that is intended to enhance transportation management and project delivery. The specific proposals were not available at the time of this analysis, but will be analyzed upon transmission to the Legislature.

General Government

Statewide Issues

Restructuring the State's Pension System

A series of employee compensation adjustments and pension reforms are proposed for overall savings of $876.7 million in 2005-06 and $1.1 billion by 2006-07. State employees and California's public school teachers currently participate in defined benefit pension plans. These pension plans provide generous benefits for each employee throughout retirement, extend these benefits to a spouse who outlives the employee, and often provide protection against future inflation that can erode the value of a pension over time. However, these benefits have come at a steep cost. At the urging of State employee organizations, the State improved the pension benefits for its employees with the promise that the new benefits could be funded by using "excess funds in the system" with no cost to the taxpayers. Meanwhile, the teachers through their unions successfully argued that the State should not terminate its contributions to CalSTRS (as was due to occur in the year 2000); rather, the system permitted teachers to divert a portion of their contributions to CalSTRS in order to establish a new annuity program. These actions have cost billions.

What is a defined contribution plan?
A defined contribution plan provides an individual account for each participant. The benefits are based on the amount contributed and are also affected by income, expenses, gains and loses. Some examples of defined contribution plans include 401(K) plans, 403(b) plans, employee stock ownership plans and profit sharing plans.

What is a defined benefit plan?
A defined benefit plan promises the participant a specific monthly benefit at retirement and may state this as an exact dollar amount. Monthly benefits are calculated through a formula that considers a participants salary and service.

It is not an easy task to compare the defined benefit plans among states. This is because there are so many variables that affect the level of pension benefits. However, the Legislative Analysts Office last year attempted to compare five states defined benefits plans to California's plan. As shown in the table below, the LAO study concluded that California's benefits are more generous than the other states studied in its sample:

California Retirement Benefits
Compared to Selected Other States

	Employee Retiring in 2004 at Age[a]				Employee Contribution
	55	60	62	65	
California	$25,200	$36,098	$40,958	$46,500	5%
Florida	11,914	20,424	24,439	28,410	---
Illinois	—b	24,250	26,115	28,913	4%
Oregon	15,242	24,831	26,741	29,606	6%
Texas	—b	34,199	36,829	40,775	6%

a Assumes employee started working for the state at age 34 and has earned $60,000 in salary in the last year before retirement.
b Not eligible for retirement at this age.

- **Public School Retirement System.** The Budget reflects that the full responsibility for annual payments to CalSTRS for the Defined Benefit Program will be shifted to school districts and/or covered employees. Initially, school districts will be expected to pay an additional 2 percent of payroll, but they will be provided authority to shift this cost through collective bargaining agreements. This shift in financial responsibility will reduce General Fund expenditures by $469 million in 2005-06. The proposal also allows teachers to opt out of the newly created Defined Benefit Supplement Program. Those teachers who choose to opt out will realize an immediate increase in take-home pay equal to a 2-percent raise. These revisions to the funding scheme for CalSTRS' programs will align the compensation value of new benefits with the responsibility to pay the costs of those benefits.

- **State Employee Retirement Programs**. The Budget assumes employees will be expected to pay one-half of the total charges approved by the CalPERS Board of Administration, including both the charges for normal costs (the actuarial costs of future benefits) and the charges for any unfunded liability. This is a sharp increase over what most State employees currently pay (for a miscellaneous Tier I employee, it will mean an increased employee contribution from 5 percent to 11 percent of their pay). This new method of funding the State's defined benefit pension plans will be phased in as collective bargaining agreements are renegotiated. The Budget also proposes to permit State employees to opt out of CalPERS, in which case the State will share the savings by paying the employee an extra stipend equal to 50 percent of the normal retirement cost for that employee. The combined General Fund savings from the changes is estimated to be $296 million in 2005-06.

- **Other Employee Compensation Proposals**. The budget also includes proposals to (1) allow the Governor to furlough State employees for up to 5 full days, (2) reduce the State contribution to health care benefits and require a 6 month "probationary" period before health benefits are provided, (3) eliminate two State holidays, (4) exclude leave time from "time worked" for the purposes of calculating overtime, and (5) place a cap on the accrual of vacation and annual leave.

- **Constitutional Amendment**. Although outside the budget process, the Governor supports a constitutional amendment to prohibit the State and any of its political subdivisions from offering defined benefit retirement programs to new employees. Many cities and counties have also experienced "runaway" pension costs that threaten the solvency of these entities.

Pension Obligation Bonds. The Administration continues to assume $765 million in revenue from the planned sale of pension obligation bonds in 2005-06. The Pacific Legal Foundation has filed a lawsuit to stop the sale of these bonds, because the State Constitution forbids State borrowing in excess of $300,000 without a vote of the people. The Administration may have to propose additional reductions or fiscal solutions later this Spring if these bonds cannot be sold.

Capital Outlay. The Budget proposes $1.2 billion in capital outlay expenditures for 2005-06, exclusive of K-12 schools, transportation and State conservancies. Funding for this program comes from multiple fund sources including $73.7 million, General Fund; $144.9 million, lease-revenue bonds; $85.8 million from other funds; and $882.4 million from higher education bonds and other General Obligation bonds.

General Obligation Bonds. California owes $33.8 billion in principal on outstanding, non-self liquidating general obligation (GO) bonds as of November 1, 2004. The General Fund cost for the payment of interest and redemption on these bonds is $3.1 billion in 2004-05 and is estimated at $3.3 billion in 2005-06. This amount could vary depending on the actual amount of bonds sold during the year.

Lease-Revenue Bonds. The State uses lease-revenue bonds to supplement the GO bond program. Outstanding lease-revenue bonds totaled $7.2 billion as of November 1, 2004, and are estimated to total $7.8 billion as of June 30, 2005, and $7.9 billion as of June 30, 2006. The General Fund cost for lease payments (principal and interest) is estimated to be $707 million in 2004-05 and $811 million in 2005-06.

Strategic Sourcing. The Budget includes expansion of an initiative to capture $95 million General Fund in anticipated savings in 2005-06 through a new procurement methodology. Begun in the Budget Act of 2004, Strategic Sourcing is a procurement reform for purchasing goods and services basis with emphases on saving through purchasing in bulk. Although the Budget Act of 2004 anticipated savings of $96 million from this initiative, the Administration now assumes it will achieve savings of roughly $48 million in 2004-05. The Department of Finance has yet to finalize an allocation plan for the savings.

Unallocated Reduction. The Budget includes an unallocated $150 million General Fund reduction to State operations. This level of savings can be achieved through departmental hiring freezes, lay-offs, permanent reductions, or other administrative efficiencies. The Budget Act of 2004 also included an unallocated reduction of $150 million.

Departmental Issues

Franchise Tax Board. The Franchise Tax Board (FTB) administers the Personal Income Tax and Corporation Tax laws, which consist of self-assessment, filing enforcement, audit and tax collection activities. These activities contribute approximately 60 percent of the General Fund's major tax and license revenue. The Budget proposes $699.6 million ($512 million General Fund and $187 million in various other special funding sources) for the FTB in 2005-06, which is net increase of $81 million over the revised current year. Additional proposals in the budget include:

- $1.8 million and 17 positions to increase staffing for the Abusive Tax Shelter Taskforce.
- $26.1 million General Fund and $52.9 reimbursement authority to continue development of a single Statewide Child Support Enforcement Automation System.
- $8.6 million and 99.2 positions to reduce the tax gap. Tax gap is the difference between what taxpayers owe and what the voluntarily pay. The proposal includes enhanced detection of tax preparer fraudulent returns, additional audit staff, underground economy criminal investigations, identification of non-filers through the use of additional information sources, and informant rewards.
- Unallocated reduction of $7.8 million.

Board of Equalization. The Board of Equalization (BOE) administers 23 tax programs, including sales and use tax and the motor vehicle fuel tax. These programs generate approximately 33 percent of the State's revenues. The Budget proposes $364.8 million ($209.4 General Fund and $155.4 million in various other special funds and reimbursement authority) and 3,627 positions for an increase of $6.3 million over the revised current year. The budget includes an augmentation of $5.7 million special fund and 76.8 personnel years to collect fees for the Covered Electronic Waste Recycling Act on behalf of the California Integrated Waste Management Board.

Military Department. The Budget includes $101.3 million ($33.2 million General Fund and $68.1 million in various other special funds and reimbursement authority) for a net reduction of $3.3 million over the revised current year. The budget includes an augmentation of $1.3 million General Fund and 10.5 positions to increase enrollment at the Oakland Military Institute.

California Victim Compensation and Government Claims Board (Board). The Board's primary role is to compensate victims of violent crime for certain crime-related financial costs. Compensation for the victims comes primarily from the Restitution Fund; and, the two major sources of revenue to the Restitution Fund are penalties on felony convictions and federal funds. The Budget proposes $133.2 million in 2005-06 which is an increase of $4.1 million over the revised current year.

Department of General Services

The Budget proposes $970.2 million for this fee-for-service agency that provides services to other State agencies. This funding represents an increase of $39.1 million over 2004-05.

- **Restructure the Office of State Publishing.** The Budget includes a reduction of 114 positions and $6.2 million for to reflect anticipated operational efficiencies at the Office of

State Publishing (OSP). The Administration is proposing to encourage the OSP to enhance its digital printing operations and broker more printing services to private industry.

- **Asset Management and Surplus Property Program.** Enacting reforms begun in current year, the Department of General Services will create an Internet marketing plan that increases the exposure of available properties. All of the State's real property assets will be presented online, allowing interested parties to identify other, non-surplus properties, as well.

Governor’s Office

Implementing an Administration proposal from last year, the Budget displays the full cost of the Governor’s Office in 2005-06 ($18.3 million General Fund for 185 positions). Past Governors have hidden the cost and scope of the Governor’s Office by “borrowing” positions from various State departments and agencies.

Secretary of State

The Budget proposes $76.4 million fir the Secretary of State, a decrease of $272.3 million ($10.2 million General Fund) over 2004-05.

- **Help America Vote Act Implementation.** In 2003-04 the State received $84.5 million federal funds to support activities required by the federal Help America Vote Act (HAVA) of 2002. In the spring of 2004, $264.4 million in additional federal HAVA funds were provided to the State. However, the Legislature restricted the release of a portion of the original grant and the subsequent HAVA funding pending the receipt of a plan for the use of HAVA funds and approval by the Department of Finance and the Legislature. In an initial review, the plan was rejected by the Administration in early January. Therefore, the Budget includes only a small amount of HAVA moneys for operations. An appropriation for the State’s full allocation of HAVA funds will be proposed after the Secretary of State’s plan is approved by the Administration and the Legislature.

- **Election Funding.** The Budget includes an increase of $3 million for election costs to diminish the likelihood of future deficiencies and to fund the full cost of statewide elections. The State historically has depended on the deficiency process to pay actual costs of elections by including a base amount in the Secretary of State budget and adding election costs in excess of this base amount through the deficiency process. The Secretary of State has had election related deficiencies in seven of the last ten years and in each of the last three years.

Department of Technology Services

The Budget proposes to consolidate the State's general-purpose data centers to improve the State’s information technology infrastructure. The new department will include the activities previously performed by the Stephen P. Teale Data Center, the Health and Human Services Agency Data Center (excluding the Systems Integration Division, which will be transferred to the Health and Human Services Agency) and the voice telecommunications and data networking functions of the Telecommunications Division of the Department of General Services. For 2005-06, the Budget includes $235.4 million for this new entity. Future savings are anticipated as consolidation is completed.

Public Safety and Judiciary

Judicial Branch and State Trial Court Funding. The 2005-06 Budget for the Judicial Branch (Supreme Court, Court of Appeals, Judicial Council/ Administrative Office of the Courts, Judicial Branch Facility Program and the Habeas Corpus Resource Center) totals $373.5 million.

In 2005-06, the State Trial Court Funding is combined with the Judicial Branch and is funded at $2.7 billion, which is an increase of $220 million over the revised current year for a total funding level of $3.4 billion ($1.9 billion General Fund and $1.5 billion other funds). The increase is primarily due to the restoration of one-time reductions ($60.5 million), court employee salary and benefits and court employee retirement ($4.1 million), and a baseline increase ($92.6 million) as a result of the statutory growth factor that ties operational increases to the State Appropriation Limit. The budget proposes a similar funding growth factor adjustment for the Judicial budget to take effect in 2007-08.

California Highway Patrol (CHP). The Budget proposes $1.4 billion for the CHP in 2005-06, which reflects an increase of approximately $44 million over the revised current year. The CHP's budget is supported primarily from the Motor Vehicle Account (MVA). The Budget includes $65.1 million for the 2005-06 costs of the memorandum of understanding with the California Association of Highway Patrolmen which expires after 2005-06.

Department of Justice. The Budget proposes $687.6 million ($322.5 million General Fund and $365.1 million in various special funds and reimbursement authority) for the Department of Justice in 2005-06, which reflects an increase of approximately $11 million and 65.2 positions over the revised current year.

Major proposed adjustments are:

- An augmentation of $11.2 million DNA Identification Fund, and 45.6 positions, to address workload resulting from the expanded collections of DNA, palm prints and thumbprints pursuant to Proposition 69, and 3.6 million General Fund for the Department of Corrections to obtain samples from inmates and parolees.
- An augmentation of $4 million General Fund to redesign the Criminal Justice Information System.
- A General Fund increase of $1.8 million for the Renovation of the Violent Crime Information Network (VCIN).
- A General Fund unallocated reduction of $3 million.

California Gambling Control Commission. The Budget proposes $139.6 million ($96.5 million Indian Gaming Revenue Share Trust Fund, $40.8 million Indian Gaming Special Distribution Fund, and $2.3 million Gambling Control Fund) and 88.7 positions for the California Gambling Control Commission. State Operations funding totals $13.1 million, which is an increase over the revised current year by $3 million. This budget also provides the

Commission with 21 additional positions. An augmentation of $4.8 million is included to address workload resulting from the new Tribal-State Gaming Compacts in 2004. This workload includes implementation of a State testing laboratory and field testing program, and auditing activities to ensure compliance with the new compacts and gambling laws.

Youth and Adult Correctional Agency. The Governor has submitted his Reorganization Plan #2 "Reforming California's Youth and Adult Correctional System" to the Little Hoover Commission. The proposal would reshape the Youth and Adult Correctional Agency into the new Department of Corrections and Rehabilitation. However, the Budget does not reflect the adoption of the proposal nor does it assume any savings related to streamlining or efficiencies that might be achieved as a result of implementation of the reorganization.

Department of Corrections. The Budget proposes $6.5 billion ($6.4 billion General Fund and $138 million in various special funds and reimbursement authority) and 51,848 positions for the Department of Corrections (CDC) in 2005-06, which reflects an increase of approximately $250 million General Fund and 1,575 positions over the revised current year.

CDC's inmate average daily population is projected to decline from 163,019 in 2004-05 to 162,755 in 2005-06, a decrease of 264 inmates, or 0.2 percent. However, we note that the 2004-05 May Revision estimated a 2004-05 inmate average daily population of 157,209, or 5,810 less than the current revised figures. Therefore, the average daily population estimates might once again require adjustment upward, which would result in additional budget pressure. CDC's current inmate population is approximately 164,000 and was as high as 165,000 earlier this year. The parole average daily population is projected to decrease from 103,492 in 2004-05 to 96,602 in 2005-06 a decrease of 6,890 parolees, or 6.7 percent. These projected declines are once again based upon the increasing impact of various parole reforms included in the 2003 and 2004 Budget Acts.

The major proposed adjustments are:

- Reduction of $95.3 million General Fund to reflect reductions to inmate and parole programs. Although no details are provided, we assume these would be cuts to such programs as substance abuse treatment, inmate or parolee employment, academic education, and vocational education. The Administration indicates that this reduction may be replaced with savings achieved through renegotiation of the Unit 6 collective bargaining agreement that expires at the end of 2005-06.
- $271.5 million General Fund increase related to previously negotiated compensation increases for CDC employees.
- $30.1 million General Fund and 101 position increase in order to ensure compliance with the *Plata* class action lawsuit court order to improve the delivery of medical care to inmates.
- $9.8 million General Fund to provide the necessary training for posted positions and technical assistants and adjust sick time costs to reflect usage rates.

Department of the Youth Authority. The Budget proposes $400.2 million ($350 million General Fund and $50.2 million in various special funds and reimbursement authority) for the Department of the Youth Authority (YA) in 2005-06, which reflects a net decrease of approximately $8.1 million, including a General Fund decrease of approximately $6 million from the revised current year.

YA's youthful offender (ward) population is projected to decrease from 3,430 on June 30, 2005, to 3,330 by June 30, 2006, a decrease of 100 wards. The parole population is projected to decrease from 3,790 on June 30, 2005, to 3,450 by June 30, 2006, a decrease of 340 wards.

- **Major funding pressure**. In order to address issues related to the conditions of confinement and treatment of wards at the Youth Authority, resulting from the *Farrell v. Allen* lawsuit, a final Remedial Plan and implementation schedule are currently in the negotiation and approval process. Details of this plan and associated funding needs will be provided as part of the May Revision.

- As part of the Juvenile Justice Reform proposal, which is still being developed, the Administration in collaboration with local law enforcement and juvenile justice experts is evaluating options to shift some or all of the parole population to the locals and/or limiting the types of youth that can be sent to YA. This could result in savings to the State, however, the potential fiscal and programmatic impact to the locals is unknown.

Office of the Inspector General. The Budget includes $8.8 million General Fund and 52 positions for support of the office in 2005-06. This is a reduction of $16,000 from the 2004-05 revised budget.

- **Potential budget pressure**. The Office of the Inspector General and the Department of Finance are in the process of developing a workload budget consistent with the legislative requirements of Chapter 733, Statutes of 2004 (SB 1342-Speier). The methodology will be provided as part of the May Revision.

Board of Prison Terms. The Budget proposes $72.8 million in General Fund for the Board in 2005-06, which reflects an increase of approximately $1.8 million and 54 positions over the revised current year.

Board of Corrections. The Budget proposes $73 million ($29.5 million General Fund and $43.5 million in various special and federal funds, and reimbursement authority) and 62 positions for the Board in 2005-06. The majority of funding is for grant programs to local governments.

- The Budget includes the restoration of $201.4 million in federal Temporary Assistance for Needy Families funding for county youth probation programs, these funds are provided as part of the Department of Social Services budget.

Commission on Peace Officers Standards and Training (POST). The Budget proposes $60.7 million in special fund and reimbursements for the Commission in 2004-05, which reflects an increase of approximately $6 million over the revised current year.

Citizens' Option for Public Safety (COPS)/Juvenile Justice Realignment. The Budget proposes $100 million General Fund for COPS, which provides funding for front-line local law enforcement to hire and retain additional officers and for prosecuting district attorneys.

Juvenile Justice Crime Prevention Act funding is reduced from $100 million to $25 million and is to be allocated to local governments for juvenile justice programs.

Juvenile Justice Funding. The Budget proposes $201.4 million from the federal Temporary Assistance to Needy Families (TANF) program for Juvenile Probation Services, which are included in the Department of Social Services' budget.

Small and Rural Sheriffs. This program which provides $18.5 million to 37 smaller county sheriffs departments is being eliminated.

Incarceration of Undocumented Felons. The Budget assumes that the State will receive approximately $78.5 million in federal State Criminal Alien Assistance Program funding for the 2005-06 fiscal year. These federal funds are for the partial reimbursement of the costs associated with the incarceration of the undocumented felon population in prison. The Department of Corrections and the Youth Authority expect to spend approximately $729.7 million in 2005-06 for the incarceration of undocumented persons.

Reductions to Office of Emergency Services public safety programs. In 2003-04, the OES took over administration of public safety grant programs from the abolished Office of Criminal Justice Planning (OCJP). The 2005-06 proposes to reduce local assistance funding for various public safety programs by approximately $4 million General Fund. This reduction represents an overall funding decrease of 3.8 percent. The specific programs and the amount of the reductions are as follows:

- $231,000 – Community Crime Resistance Program
- $866,000 – Career Criminal Apprehension Program
- $137,000 -- Serious Habitual Offender Program
- $172,000 -- Vertical Defense of Indigents Program
- $690,000 – Drug Abuse Suppression in Schools Program
- $1,900,000 – Rural Crime Prevention Program

Labor and Workforce Development

Employment Development Department

The Budget includes $11.6 billion ($19.2 million General Fund) for the Employment Development Department to administer the Unemployment Insurance and Disability Insurance programs, administer labor exchange and job training programs, and collect personal income tax from employers.

- **Unemployment Insurance (UI).** The Budget proposes no solutions to address the significant fund solvency issues in the Unemployment Insurance Fund caused by past UI benefit and eligibility expansions. As UI taxes paid by employers are determined by the fund balance and projected distributions, these factors have increased the average UI cost per employee by more than 85 percent in 3 years.

Source: October 2004 Unemployment Insurance Fund Forecast

- **Economic and Employment Enforcement.** The Budget includes $6.5 million for 61.7 positions for the Employment Development Department, the Department of Industrial Relations, and the Department of Consumer Affairs to target businesses operating in the "underground economy". According to the Administration, these departments will increase enforcement of California labor, employment tax, and licensing laws.

Resources, Environment and Energy

For 2005-06, General Fund expenditures for resources and environmental protection programs increased by approximately $198 million over the revised 2004-05 budget. This increase is primarily attributable to the costs for lining the All-American Canal, improving fire suppression efforts, and paying for employee compensation and debt service costs. Fees were a large portion of the budget "solutions" for the 2003-04 and 2004-05 budgets. However, the only major fee proposals in the resources and environmental protection programs for 2005-06 relate to CALFED financing, and a $6 million increase for park fees. These and other select topics are discussed below.

All-American and Coachella Canals. Consistent with the Quantification Settlement Agreement (QSA), the budget proposes $59.1 million General Fund for the lining of the All-American and Coachella canals. The QSA is an agreement between various federal, state, and local agencies to reduce California's use of the Colorado River. Lining of the canals is anticipated to reduce the amount of water that is absorbed into the ground, thereby increasing the supply of water by about 100,000 acre feet.

Department of Forestry and Fire Protection (CDF). The CDF's primary duties include oversight of the State's forests and fire suppression on the State's forestlands and State responsibility areas, also known as SRA's. For the 2005-06 fiscal year, the budget proposes funding for fire suppression activities as follows:

- $25 million for emergency firefighting costs;
- $10.8 million for the replacement of fire engines and helicopters; and
- $9 million for firefighters to provide year-round fire suppression coverage in the counties of Riverside, San Bernardino, and San Diego.

Levee maintenance. Last year, a levee break in the Jones Tract portion of the San Joaquin delta caused millions of dollars in damages. The State responded with financial assistance for levee repair and debris removal. However, as the result of a recent court ruling on the Paterno v. State of California case, the State's liability could increase substantially for future levee failures. In response, the budget includes $9.7 million General Fund and 27 positions. This funding is the first installment of a 3-year plan to improve and maintain the Sacramento and San Joaquin Valley flood system, and develop and implement a more comprehensive flood protection plan. The Administration also indicates that they are evaluating alternatives for funding flood protection activities, including creation of a special district with the authority to impose fees, and exploring possibilities for mandatory flood insurance for residents living near flood control levees.

CALFED financing proposal. CALFED is a consortium of State and federal agencies created to address various inter-related water problems in the Bay-Delta region over the next 30 years. CALFED goals include improving water quality and wildlife habitat, increasing water supply, and reducing flood risks from levees. However, since CALFED began implementing programs and project construction in 2000, federal funding commitments have fallen short. During last year's budget subcommittee hearings, the Senate adopted a proposal that required the Bay-Delta Authority to adopt regulations establishing a CALFED user fee effective in the 2005-06 fiscal year. Upon strong urging from Republicans, the Governor agreed to withdraw all language related to a CALFED fee. Since then, the Bay-Delta Authority has been working to develop a long-term financing plan.

The budget includes a 10-year CALFED financing plan that incorporates the following:

- Reduces the average annual program cost from $1.3 billion to $807 million a year.
- Reduces the State's overall contribution from 59 percent historically, to 30 percent over the next 10 years.
- Increases the federal contribution from 7 percent historically, to 21 percent over the next 10 years.
- Increases water user and local contributions from 33 percent historically, to 49 percent over the next 10 years.

The following table, provided by the Department of Finance, identifies the amount and percentage of contribution from each level of government, as well as the programs that would be funded over the next 10 years. The Administration is currently working with water users and local agencies on a methodology to finance the non-State share, and indicates that this methodology would be included as an update in the May Revision.

CALFED Bay-Delta Program **10-Year Funding Allocations by Beneficiary** **(Dollars in millions)**					
Program Element	State	Federal	Water Users	Local Match	Total Funding
Ecosystem Restoration	$542	$408	$400	$150	$1,500
Environmental Water Account	180	135	123		438
Water Use Efficiency	575	530		2,048	3,153
Water Transfers	6				6
Watershed	196	161		66	423
Water Quality	81	72	17	106	276
Levees	186	175	32	53	446
Storage	292	36	9	750	1,087
Conveyance	109	6	71		186
Science	167	151	109	10	437
Oversight & Coordination	74	47			121
Total Dollars	**$2,408**	**$1,721**	**$761**	**$3,183**	**$8,073**
Total Percentage	**30%**	**21%**	**9%**	**40%**	**100%**

Park fees. The 2004 Budget Act authorized increases for day use and camping fees in State parks. The fee revenues would be used to repair and improve State Park water, wastewater and sewer systems to help comply with State and federal legal mandates for drinking water and waste discharge. In 2004-05 Park fees were restructured on a sliding scale based on peak demand and park popularity. The fee increases proposed for 2005-06 will remain within previously authorized ranges, and is anticipated to generate an additional $6 million in revenue.

Williamson Act. The budget proposes to maintain subvention funding for the Williamson Act at approximately $40 million.

River Parkways. The budget proposes $7,850,000 from Proposition 40 bond funds, and $30,500,000 from Proposition 50 bond funds to provide grants to public and nonprofit entities for river parkway projects. Specifically, these funds would be used for the acquisition and development of river parkways.

Sierra Nevada Conservancy. The budget proposes $3.6 million and 13.5 positions to support the newly created Sierra Nevada Conservancy, and $11.7 million in Proposition 50 bond for grants to public and nonprofit entities for the acquisition of land and water rights that would protect water quality in the region.

Energy. Although wholesale energy supplies and prices are currently stable, many forecasters predict that California could be impacted by another energy shortage in the new few years. In order to mitigate a reoccurrence of the energy crisis of 2000, the Administration indicates it is undertaking a series of actions that would reduce the risk of an energy shortage, such as:

- Encouraging utilities to enter into long-term contracts with energy providers.
- Requiring utilities to maintain 15-percent electricity reserves by 2006.
- Establishing a process for the competitive procurement of power by the utilities.
- Allowing large customers to choose their own power supplier.
- Finding ways to expand transmission infrastructure.

- Accelerating the Renewal Portfolio Standard requirement of 20 percent to 2010, instead of 2017.
- Encouraging residents and businesses to increase their use of solar energy.
- Increasing energy efficiency in State buildings, while reducing energy use.

Local Government

The Budget continues to support high-priority programs of mutual concern to both State and local government, such as public safety, health and human services, housing, transportation, and resources. The funding for these programs totals nearly $5.6 billion.

Local Government Agreement. The budget assumes $1.3 billion of annual General Fund savings in 2004-05 and 2005-06 by reducing payments to, or shifting funds from, local governments.

Property Tax Administration Grants. Grants to counties for property tax administration are funded at $54.3 million, which is a reduction of $5.7 million from 2004-05.

Senate Republican Fiscal Staff Assignments

Jeff Bell, Staff Director
(916) 323-9221

Laurie Hall, Committee Assistant
(916) 323-9221

Assignment Area	Consultant	Phone
Education	Cheryl Black	324-1031
Public Safety & Judiciary Local Government	Doug Carlile	324-5226
Human Services, General Government	Eric Swanson	324-5237
Health	Seren Taylor	322-3213
Transportation, Resources, Environment, & Energy	Therese Tran	324-5537

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